85-674

Supreme Court, U.S.
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JOSEPH F. SPANIOL, JR.
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NO. _____

IN THE

Supreme Court of The United States

October Term, 1985

KENTON MEADOWS COMPANY, INC., etc., et al., ... Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, ... Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

David K. Higgins
Robinson & McElwee
Post Office Box 1791
Charleston, West Virginia 25326
(304) 344-5800

Attorney for Petitioners

JARRETT PRINTING CO., CHARLESTON, WV

qapp

QUESTIONS PRESENTED

(A) DOES THE DETERMINATION OF THE "ACTIVE CONDUCT OF A TRADE OR BUSINESS" FOR PURPOSES OF AN I.R.C. §346(b) PARTIAL LIQUIDATION REQUIRE A FACTUAL FINDING OF SEPARATE CONTROL AND MANAGEMENT AND SUBSTANTIAL INCOME PRODUCTION FOR THE BUSINESS TERMINATED?

(B) IF SO, UPON WHAT AUTHORITY DOES THE INTERNAL REVENUE SERVICE RELY IN TAKING A POSITION CONTRARY TO ITS OWN PROPOSED §346 REGULATIONS WHICH PROVIDE THAT SEPARATE CONTROL AND MANAGEMENT AND SUBSTANTIAL INCOME PRODUCTION ARE NO LONGER REQUIRED UNDER I.R.C. §346?

LIST OF PARTIES BELOW

The Petitioner in the Fourth Circuit Court of Appeals was Kenton Meadows and Acel I. Meadows, husband and wife and Kenton Meadows Company, Inc.* The Respondent in that Court was the Commissioner of Internal Revenue. There were no other parties before the Fourth Circuit Court of Appeals in this matter.

*Petitioner Kenton Meadows Company is an affiliate of Elk Valley Land Corporation. KMS, Inc. is a subsidiary of the Petitioner.

TABLE OF CONTENTS

Item	Page
Question Presented	i
List of Parties Below	i
Table of Contents	ii
Table of Authorities	iii
Opinion Below	1
Statement of Jurisdiction	1
Statutes and Regulations Involved	2
Statement of the Case	2
Jurisdiction of Tax Court	3
Reasons for Granting Writ	4
Conclusion	15
Appendix	1a

TABLE OF AUTHORITIES

Cases Page

Blaschka v. United States,
393 F.2d 983 (Ct. Cl. 1968) 5, 14

Coady v. Commissioner, 33 T. C. 771
(1960), *aff'd per curium*, 289 F.2d 490
(6th Cir. 1961)..... 6, 7, 8, 9, 10, 11, 12, 13, 14

H. Grady Lester, Jr.,
40 T. C. 947 (1963)..... 10, 11, 12

Main v. United States,
508 F.2d 1251 (6th Cir. 1975),
cert. denied 439 U.S. 981 (1978) 5, 14

Rafferty v. Commissioner of Internal Revenue,
452 F.2d 767 (1st Cir. 1971),
cert. denied 408 U.S. 922 (1972) ... 6, 8, 9, 13, 14

United States v. Marett,
325 F.2d 28 (5th Cir. 1963)..... 6, 8, 9, 13, 14

STATUTORY PROVISIONS

26 U.S.C. §301 3

26 U.S.C. §302 ..... 3, 12

26 U.S.C. §311 3

26 U.S.C. §346 .... 3, 4, 7, 8, 9, 10, 11, 12, 14, 15

26 U.S.C. §355 .... 5, 6, 7, 8, 9, 10, 12, 13, 14, 15

Tax Equity and Final Responsibility Act
of 1982, Pub. L. No. 97-248, 96 Stat. 324..... 12

Treasury Regulations on Income Tax
26 C.F.R. §1.346-1 7
26 C.F.R. §1.355-1 ..... 5, 6, 7, 8, 12, 13, 14

TABLE OF AUTHORITIES (Continued)

Proposed Treasury Regulation
Federal Register January 1, 1985
Proposed Treas. Reg. §1.355-1..... 7, 8, 14

Revenue Rulings
Rev. Rul. 75-160, 1975-1 C.B. 112 ..... 7, 8, 14

OPINION BELOW

The opinion of the United States Court of Appeals for the Fourth Circuit (No. 84-2283) whose judgment is herein sought to be reviewed, was decided and filed on June 26, 1985. Said opinion has been recommended for full text publication, but as of this time is yet to be published. A copy of the opinion is reprinted in the Appendix hereto, *infra,* pages 1a-7a. A petition for rehearing directed to the Fourth Circuit was denied on July 23, 1985. A copy of that order is reprinted in the Appendix hereto, *infra,* page 8a. The Memorandum Finding of Facts and Opinion of the Tax Court was filed July 24, 1984 and is recorded in T. C. Memo. 1984-379. A copy of said Memorandum Finding of Fact and Opinion is reprinted in the Appendix hereto, *infra,* pages 9a-35a. The decision of the Tax Court is unreported. A copy of said decision is reprinted in the Appendix hereto, *infra,* page 36a.

STATEMENT OF JURISDICTION

The judgment of the Fourth Circuit Court of Appeals (Appendix, *infra,* page 1a) was entered on June 26, 1985. A timely petition for rehearing was denied on July 23, 1985 (Appendix, *infra,* page 8a). The jurisdiction of this Court is invoked under 28 U.S.C. §§1254(1) and 2102(c).

STATUTES AND REGULATIONS INVOLVED

The statutes involved in this case, and the page numbers in the Appendix where they are set out verbatim are 26 U.S.C. §301 at (A. 37a); 26 U.S.C. §302 at (A. 42a); 26 U.S.C. §311 at (A. 48a); 26 U.S.C. §346 at (A. 53a); and 26 U.S.C. §355 at (A. 53a). The Treasury Regulations on Income Tax that are involved are 26 C.F.R. §1.346-1 at (A. 57a); and 26 C.F.R. §1.355-1 at (A. 60a). The Proposed Treasury Regulation involved is Proposed Treas. Reg. §1.355-1 at (A. 67a).

STATEMENT OF THE CASE

On June 15, 1977, the Internal Revenue Service (as a result of a field audit) issued two statutory notices of deficiency for tax years ending December 31, 1972 and December 31, 1973, one to Kenton Meadows Company, Inc., a West Virginia corporation, and the second to Kenton Meadows and Acel I. Meadows, his wife. The notice directed to Kenton and Acel I. Meadows sought additional taxes of $65,543.00. The upward income adjustment was $107,000.00 and related to bank stock used as working capital by Kenton Meadows Company, Inc., in the cross-country pipeline construction business. This bank stock had been distributed to Kenton Meadows individually upon termination of the pipeline business by the company. In exchange for the distributed bank stock, Kenton Meadows Company, Inc., redeemed a portion of his stock in Kenton Meadows Company, Inc.

The notice of deficiency directed to Kenton Meadows Company, Inc. sought payment of $22,746.00 in additional taxes for the period in question again re-

lating to the distribution of bank stock as appreciated property.

A timely notice for redetermination was filed in September of 1977 with answers by the government being filed in October of 1977. The case was tried on June 17, 1981.

The government contended that distribution of the bank stock to Kenton Meadows and the redemption of company stock was a distribution essentially equivalent to a dividend under I.R.C. §302(d) and therefore taxable to Kenton Meadows individually as ordinary income under I.R.C. §301 and taxable to the company as a distribution of appreciated property under I.R.C. §311(d) (1). The taxpayer contended that the distribution of the bank stock by the company and the redemption of outstanding company shares was a partial liquidation of Kenton Meadows Company, Inc. due to termination of the cross-country pipeline construction business and therefore qualified under I.R.C. §346(b) as a capital gain distribution to Kenton Meadows individually and not taxable to the company by virtue of I.R.C. §336.

The Tax Court rendered a decision in favor of the government on all counts July 24, 1984. Appeal was taken to the Fourth Circuit Court of Appeals wherein the Fourth Circuit affirmed the Tax Court decision. A subsequent petition for rehearing before the Fourth Circuit was denied on July 23, 1984.

JURISDICTION OF THE TAX COURT

Subject matter jurisdiction in this case was conferred upon the United States Tax Court by 26 U.S.C. §§7442 and 6214.

REASONS FOR GRANTING WRIT

I. THE HOLDING OF THE COURT OF APPEALS FOR THE FOURTH CIRCUIT THAT A BUSINESS CANNOT QUALIFY A DISTRIBUTION UNDER I.R.C. §346(b) UNLESS THE TERMINATED BUSINESS IS UNRELATED TO THE REMAINING BUSINESS, HAS SEPARATE ACCOUNTING AND SEPARATE MANAGEMENT RAISE IMPORTANT QUESTIONS THE SUPREME COURT SHOULD ADDRESS.

The government in this case seeks to impose a requirement that two separate and distinct trades or businesses must be proven before the safe harbor provision of I.R.C. §346(b) will apply to allow distribution of the proceeds of a termination in redemption of corporate stock at capital gain rates. Section 346(b) of the I.R.C., prior to amendment in 1982 and as applicable to this case, reads as follows:

> (b) Termination of a business.—A distribution shall be treated as a distribution described in subsection (a) (2) if the requirements of paragraphs (1) and (2) of this subsection are met.
>
> (1) The distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.
>
> (2) Immediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the

distribution and was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

Whether or not a distribution meets the requirements of paragraphs (1) and (2) of this subsection shall be determined without regard to whether or not the distribution is pro rata with respect to all of the shareholders of the corporation.

The statute does not expressly require that two operationally distinct businesses be conducted during the requisite five year period preceding distribution. The Fourth Circuit Court of Appeals relied on the decisions in *Main v. United States*, 508 F.2d 1251, (6th Cir. 1975), *cert. denied* 439 U.S. 981 (1978) and *Blashka v. United States*, 393 F.2d 983 (Ct. Cl. 1968) for purposes of holding that the definition of actively conducted trade or business as found in Treas. Reg. §1.355-1 requires a factual showing of the existence of two operationally distinct trades or businesses prior to the termination. The Fourth Circuit Court of Appeals therefore held that to prove a separate active business there must be a finding of substantial income contribution to total corporate income by the terminated business and some form of separate supervision and control over the terminated business. These factors relate to the view, *once held by the Internal Revenue Service*, that a single business could not divide itself into two corporations and thereafter qualify as an active trade or business for the five years preceding distribution of the new corporation under I.R.C. §355. In 1977, for the reasons stated below, the Internal Revenue Service abandoned that position.

The single business prohibition contained in the old

(pre-1977) regulations was attacked in the seminal case of *Coady v. Commissioner,* 33 T. C. 771 (1960) *aff'd. per curium,* 289 F.2d 490 (6th Cir. 1961). In that case the Tax Court held that the explicit prohibition of the division of a single business under then Treas. Reg. §1.355-1(a) was invalid. The Tax Court opined that the regulation did not reflect Congressional intent which was to distinguish passive versus active assets and therefore was void. Implicit in the Tax Court's holding in *Coady* was that the determination of "active conduct of a trade or business" under Treas. Reg. §1.355-1(c) did not require two operationally distinct businesses. That implication was expressly reaffirmed in *Rafferty v. Commissioner,* 452 F.2d 767 (1st Cir. 1971), *cert. denied* 408 U.S. 922 (1972). That court rejected the Commissioner's assertion that Treas. Reg. §1.355-1(c) mandated two separate income producing entities stating "[t]he correctness of these regulations is questionable in view of the rejection of the separate business requirement of §1.355-1(a) in *United States v. Marett,* 325 F.2d 28 (5th Cir. 1963) and *Coady v. Commissioner of Internal Revenue.*" 452 F.2d at 772.

The Court in *Rafferty* then replaced the Commissioner's separate business requirement with an "entrepreneurial endeavors" test which serves to distinguish activities that are more than merely passive investments. This test, the Court held, would better reflect the interest of Congress to exclude passive investments from favorable corporate reorganization tax treatment under §355.

The Internal Revenue Service thereupon rejected its earlier Treas. Reg. §1.355 and adopted the findings in *Coady, Marett,* and *Rafferty* as the new standard to

determine "active conduct of a trade or business". This change was announced in Rev. Rul. 75-160, 1975-1 C.B. 112. After publishing Rev. Rul. 75-160, the IRS proposed new Treas. Reg. §1.355 to incorporate both case law and the Service's new position on the determination of "active conduct of a trade or business" for purposes of I.R.C. §355. (Federal Register Jan. 21, 1977) The IRS also proposed new Treas. Reg. §1.346-1 which requires referral to the new determination of "active conduct of a trade or business" under I.R.C. §355 for purpose of I.R.C. §346 partial liquidations.

The failure of the Fourth Circuit Court of Appeals to realize that there is no longer a legal requirement under I.R.C. §346 that the terminated business be operationally distinct from the remaining business and the odd fact that the government is advancing with obvious success a position which it abandoned eight years ago raises serious questions that this Court should address.

Since the Fourth Circuit Court of Appeals did not specifically address the change both in the law and the Service's position on a determination of "active conduct of a trade or business" it is unclear whether the Court of Appeals intended to reject the Service's position and return to the pre-*Coady* separate business requirement or whether the Court of Appeals was unaware of the present day standard. In either case it is respectfully submitted that this Court resolve this ambiguous issue, bring the law under I.R.C. §346 into conformity with its statutorily controlling counterpart which is I.R.C. §355 and prevent the Internal Revenue Service from extracting significant taxes based upon a legal position which the Service abandoned eight years ago.

II. THE INTERNAL REVENUE SERVICES EXPRESSLY ANNOUNCED POSITION ON THE DETERMINATION OF "ACTIVE CONDUCT OF A TRADE OR BUSINESS" FOR BOTH I.R.C. §355 AND §346 IS UNDERMINED BY THE DECISION OF THE COURT OF APPEALS IN *MEADOWS*. BY RULING FOR THE COMMISSIONER OF INTERNAL REVENUE IN THIS CASE THE FOURTH CIRCUIT HAS IMPOSED A DIFFERENT STANDARD FOR THAT CIRCUIT PLACING THE FOURTH CIRCUIT IN CONFLICT WITH THE FIRST, FIFTH AND SIXTH CIRCUITS.

For several years after enactment of the 1954 Code, the Internal Revenue Service followed a "two separate business" doctrine which required that each business must meet the "every step" test in order to have both businesses qualify as being engaged in the "active conduct of a trade or business." After the rejection of this doctrine in *Coady* and *Marett,* the Service acquiesced but only to the extent of the prohibition of a single business division found in Treas. Reg. §1.355-1(a) and then only to the extent that this division was vertical (i.e., the "every step" test was still a requirement). The expansion to include functional divisions, abolition of the "every step" test and the shift in concern to whether assets are active or passive occurred in *Rafferty,* Rev. Rul. 75-160, 1975-1 C.B. 112, and the new proposed Treas. Reg. §1.355. All the above clearly indicate (the Fourth Circuit in *Meadows* notwithstanding) that a determination of "active conduct trade or business" for the requisite five years preceding termination no longer requires substantial income contribution or separate management and control. Rather, the test is whether the assets to be liquidated in a §346(b) termination are active assets of the business terminated. At the urging of the Internal Revenue Service, the Fourth Circuit Court of Appeals

has returned to the rejected "separate business" and "every step" standard.

The assets sold by the Petitioner company were all obviously involved in the entrepreneurial endeavors of the Kenton Meadows Company and therefore under *Rafferty, Coady* and *Marett* constituted assets used in a trade or business under I.R.C. §346. It is difficult to understand why the Service continues to argue a position that it abandoned eight years ago. Revenue collection is assuredly not as important as fair and uniform application of the tax laws.

In this case, the "active conduct of a trade or business" requirement was met and I.R.C. §346(b) treatment should have been granted. The Fourth Circuit Court of Appeals has ruled against the expressly stated Service position and the Service continues to advance a judicially rejected legal position. Such a situation is untenable from the standpoint of fair administration of the tax law. If *Meadows* is not reversed then there will be one tax treatment for corporate reorganizations under I.R.C. §346 and I.R.C. §355 when a determination of active conduct of a trade or business is made in the First, Fifth and Sixth Circuits; and a different treatment in the Fourth Circuit even though the announced requirements of the Service are met in both instances.

III. THE TAX COURT FAILED TO FOLLOW ITS OWN CASE LAW PRECEDENT BECAUSE IT REQUIRED A SHOWING OF TWO SEPARATE ACTIVE TRADES OR BUSINESSES WHERE BOTH BUSINESSES HAD TO MEET THE "EVERY STEP" TEST.

The Tax Court has had occasion to fashion rules to aid in interpreting what constitutes the "active conduct of a trade or business." In *Coady v. Com-*

missioner, 33 T. C. 771 (1960), *aff'd. per curium* 289 F.2d 490 (6th Cir. 1961) the Tax Court allowed active trade or business status for the requisite preceding five year period to companies formed from the division of a single integrated construction company. The Tax Court could find no support for the position maintained by the Service to the effect that two separate operationally distinct businesses must exist for the five years preceding seperation.

In *Coady,* the taxpayer, (an integrated construction company) placed a construction contract, construction equipment and cash in a separate company and the Tax Court held that the new company qualified as a separate trade or business. Here, Petitioner Meadows Company completed its construction contracts, sold its construction equipment and distributed bank stock (a cash equivalent) and yet the Tax Court and the Fourth Circuit have held and the Service contends that such assets do not constitute a trade or business under I.R.C. §346.

In the case of *H. Grady Lester, Jr.,* 40 T. C. 947 (1963) the Service maintained that an integrated business existed and that therefore a separation would not be deemed to create two active trades or businesses under I.R.C. §355. The Tax Court states:

> We do not think the fact that the two activities may have been conducted by the same company at the same location and with the same employees and that the income and expenses of each were not separately reflected in its books and records, makes the two activities any less two separate businesses under the above definition" (Treas. Reg. 1.355-1(c))

40 T. C. at 958

Under either of two characterizations of the facts in *Meadows,* (1) that Kenton Meadows Company, Inc., was a single integrated construction company with various contracts including large cross-country pipeline construction contracts; or (2) that Kenton Meadows Company, Inc., after the 1970 merger of the three separate companies was still involved in separate businesses with interelated internal supervision and accounting therein; the Tax Court and the Fourth Circuit under the dictates of *Coady* or *Lester* should have allowed I.R.C. §346(b) favorable tax treatment upon termination of the cross-country pipeline construction business in 1972 by the Petitioner.

Instead, the Tax Court refused I.R.C. §346(b) tax treatment because the cross-country pipeline construction business was not, in the Tax Court's opinion, an actively conducted trade or business. The Tax Court stated:

> We cannot find that the operation of the company was anything other than an integrated operation involving various kinds of heavy and highway construction work including pipeline construction. (Appendix p. 26a-27a)

The Tax Court then refused to find that the cross-country pipeline construction business contributed substantial income to the corporation when the uncontroverted evidence including corporate tax returns and oral evidence was that prior to the 1970 merger, Pipeline Maintenance & Construction, Inc. generated over one-half of the total gross income of the three corporations combined, and after the merger contributed over one-half of the gross income of Kenton Meadows Company, Inc. The Fourth Circuit Court of Appeals did note that in light of this evidence the

refusal of the Tax Court to find substantial income contribution was "questionable." (Appendix p. 5a)

For the Tax Court and the Fourth Circuit to reimpose the pre-1977 discarded "every step" standard does violence to the tax laws and creates a distorted tax trap for the unwary. Taxpayers attempting to follow the Internal Revenue Service announced standards to determine "active conduct of a trade or business" for purposes of corporate reorganizations under I.R.C. §355 and I.R.C. §346 (changed in 1982 TEFRA to §302(b) (4) and (e)) will be met with a dilemma. The Service may choose to deny favorable tax treatment on the basis of *Meadows,* or it may now pick and choose which standard to apply; either *Coady* and *Lester* or *Meadows.* To avoid this situation it is respectfully submitted that this Court resolve the issue and bring the Internal Revenue Service, the Tax Court and the Fourth Circuit back into line with the First, Fifth and Sixth Circuits and ironically with the Service's own proposed regulations and prior Tax Court decisions which forced the change in the regulations.

IV. THERE IS A SERIOUS CONFLICT AMONG THE COURTS OF APPEAL ON THE QUESTION RAISED BY THIS CASE.

The Fourth Circuit's holding that two separate businesses must be actively conducted for the five years preceding partial liquidation with each business required to prove both substantial income contribution and separate management and control is in direct conflict with other circuits on this issue of "separate business" requirement and Treas. Reg. §1.355-1(c).

The Sixth Circuit has held that it does not interpret

Treas. Reg. §1.355-1 to require that there be two separate businesses for the five year period preceding corporate reorganization. *Coady v. Commissioner,* 33 T. C. 771 (1960), *aff'd. per curium* 289 F.2d 490 (6th Cir. 1961). The Sixth Circuit allows a single integrated construction company to divide for purposes of I.R.C. §355 and each company will be deemed to be an actively conducted trade or business for the preceding five years. There is no requirement in the Sixth Circuit that there be substantial income production or separate management and control before the division.

The Fifth Circuit, in the post *Coady* case of *United States v. Marett,* 325 F.2d 28 (5th Cir. 1963) upheld a District Court summary judgment based on *Coady.* There, the facts showed a single active business for the five years preceding a §355 distribution. The Fifth Circuit noted that the requirement of a separate trade or business before distribution had no basis under the statute and therefore Treas. Reg. §1.355-1 was invalid. Therefore, the Fifth Circuit does not require the type of showing mandated in *Meadows* by the Fourth Circuit.

The First Circuit expanded the decisions of *Marett* and *Coady* by finding that the active business definition of Treas. Reg. §1.355-1(c) was based in part on the rejected separate business requirement of Treas. Reg. §1.355-1(a). The *Rafferty* court therefore replaced the rejected test with an "entrepreneural endeavors" test that better reflected the congressional concern with spin-offs or terminations of active v. passive assets. Therefore, likewise, the First Circuit has rejected the Fourth Circuit position.

Because of these conflicting results arising between the circuits on the issue of a determination of active

conduct of a trade or trade or business it is respectfully requested that this Court resolve these conflicts.

V. THE COURT OF APPEALS ERRED IN DISALLOWING I.R.C. §346(b) PARTIAL LIQUIDATION TREATMENT OF TAXPAYER'S CROSS-COUNTRY PIPELINE CONSTRUCTION BUSINESS.

The Fourth Circuit improperly concluded that to find an "actively conducted trade or business" there must be separate management and control and substantial income contribution. The Fourth Circuit derived this requirement from two cases, namely *Blaschka v. United States,* 393 F.2d 983 (Ct.Cl. 1968) and *Main v. United States,* 508 F.2d 1251 (6th Cir. 1975), *cert. denied* 439 U.S. 981 (1978). Both of these cases involved the now discarded "separate business" and "every step" test. The cases of *Coady, Marett,* and *Rafferty,* Rev. Rul. 75-160 and the new proposed Treas. Reg. §1.355 all reflect the rejection of this "separate business" and "every step" test. The *Rafferty* court replaced these tests with an "entrepreneural endeavors" test. That test distinguishes active versus passive assets and as such better reflects congressional intent (S.Rep. No. 1622, 83d Cong., 2d Sess. 50-51 (1954)). The *Rafferty* test allows both functional and vertical divisions of a single integrated business. The Fourth Circuit erred in following the discarded separate business standard. If *Meadows* is allowed to stand, the tax treatment of corporate reorganizations under I.R.C. §346 and I.R.C. §355 will become fortuitous. It is respectfully requested this Court resolve this issue.

CONCLUSION

The decision of the Fourth Circuit in *Meadows* denies I.R.C. §346(b) partial liquidation tax treatment because the business terminated did not have separate management and control or produce substantial income but rather was an integrated part of the total company business. This requirement is based on the "separate business" and "every step" test which has been expressly rejected by the Internal Revenue Service and case law in three other circuits. As such, the Fourth Circuit's finding defeats the very purpose for which I.R.C. §346(b) was enacted. To allow such decision to stand will create a split in the circuits. By reimposing the "separate business" and "every step" test the Fourth Circuit's decision will destroy favorable tax treatment to corporate reorganizations under I.R.C. §346 and §355 in many instances as well as defeating the Congressional intent in requiring "active status" to distinguish active v. passive assets.

Respectfully submitted,

David K. Higgins

Counsel for Petitioners

Robinson & McElwee
Post Office Box 1791
Charleston, West Virginia 25326
Telephone: (304) 344-5800

APPENDIX

APPENDIX

Page

Opinion of the United States Court of Appeals for the Fourth Circuit 1a

Order of the United States Court of Appeals for the Fourth Circuit denying petition for rehearing..... 8a

United States Tax Court's Memorandum, Finding of Fact and Opinion dated July 24, 1984 ..... 9a

Decision of the United States Tax Court dated July 25, 1984.....36a

Statutory Provisions

26 U.S.C. §301 .....37a

26 U.S.C. §302 .....42a

26 U.S.C. §311 .....48a

26 U.S.C. §346 .....53a

26 U.S.C. §355 .....53a

Treasury Regulations on Income Tax

26 C.F.R. §1.346-1 .....57a

26 C.F.R. §1.355-1 .....60a

Proposed Treasury Regulation

Proposed Treas. Reg. §1.355-1.....67a

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 84-2283

KENTON MEADOWS COMPANY, INC.,
A West Virginia Corporation,
KENTON MEADOWS and ACEL I.
MEADOWS, Husband and Wife,

Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,
Appellee

Appeal from the decision of the United States Tax Court. Edna G. Parker, Trial Judge. (C/A 9533-77).

Argued: May 7, 1985 Decided: June 26, 1985

Before PHILLIPS and SPROUSE, Circuit Judges, and WARD, District Judge for the Middle District of North Carolina, sitting by designation.

David K. Higgins (Robinson & McElwee on brief) for Appellant; Thomas M. Preston (Michael L. Paup; Jonathan S. Cohen; Glenn L. Archer, Jr., Assistant Attorney General, Tax Division, Department of Justice, on brief) for Appellee.

WARD, District Judge

One corporate and two individual taxpayers chal-

lenge the June 25, 1984 decision of the United States Tax Court setting income tax deficiencies owed by Kenton Meadows Company, Inc. at $19,695 and $3,051 and by Kenton and Acel I. Meadows at $64,641 and $902 for the 1972 and 1973 tax years, respectively. Two issues are raised on appeal: (1) whether the Tax Court erred in determining that a distribution of bank stock owned by the corporate taxpayer in exchange for a portion of its outstanding stock was a distribution of property taxable as a dividend rather than as a capital gain resulting from a partial liquidation under 26 U.S.C. §346(b),[1] and (2) whether the Tax Court erred in finding that certain travel expenses were not deductible business expenses under section 162. The amount of the assessed deficiencies is not in question.

The material facts are largely stipulated by the parties and are detailed in the Tax Court opinion. At all times relevant Kenton Meadows (Meadows) was the sole shareholder of Kenton Meadows Company, Inc. (Company). On January 1, 1970, the Company merged with Pipeline Maintenance and Construction Inc., Meadows Stone & Paving, Inc., and Meadows Southern Construction, Inc., each of which was wholly owned by Meadows. Prior to the merger, the business of the Company included general contracting and equipment rental. By virtue of the merger, the Company's business also included pipeline maintenance and construction, asphalt paving, quarried stone sales, and road and bridge construction.

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[1] All subsequent section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in question.

In 1970-71, the Company's pipeline business was concentrated in construction of "cross-country" gas pipelines. Because of a shortage of liquid capital, the Company experienced difficulty in obtaining necessary bonding for pipeline construction projects. To remedy this situation and at the urging of a bonding agent, Meadows transferred 150 shares of personally owned bank stock to the Company and received 550 shares of Company stock in return. Meadows' basis in the bank stock was $84,350. This transaction enabled the Company to acquire bonds for a four million dollar pipeline project which it completed by the end of 1971.

Unable to locate additional cross-country pipeline work, the Company decided to sell certain equipment known as "pipelayers" or "sidebooms" which were generally not adaptable for use in other construction unless the job required lifting and lowering of items comparable to the long, heavy pipe sections. Seven sidebooms were sold between January and March, 1972 for a total of $238,234. All of the sidebooms had been purchased by the Company, not Pipeline Maintenance and Construction, prior to the merger. Proceeds from the sale of the sidebooms went towards retiring "pipeline-related debt" which was collateralized not only by sidebooms but also by multipurpose equipment retained by the Company. The Company also transferred the 150 shares of bank stock back to Meadows and redeemed the 550 shares of outstanding company stock previously exchanged therefor. At the time of this transfer, January 14, 1972, the fair market value of the bank stock had increased to $107,000.

On June 2, 1972, the Company purchased a sideboom similar to those sold earlier that year. This

equipment was never used in a pipelining operation but was rented to a railroad company. Since 1972, the Company has not performed any cross-country pipelining work but has performed smaller pipelining projects known as "utility" or "station" jobs.

The taxpayers assert that cross-country pipelining was a separate trade or business and that its termination is entitled to the favored status of section 346(b).[2] For the sale of the sidebooms and transfer of the bank stock to be deemed a partial liquidation under section 346(b), there must be a finding of a trade or business which is separate from the remaining corporation. Two major factors in determining the existence of a separate trade or business can be gleaned from applicable Treasury Regulations and case law. The business must (1) contribute a substantial part of the combined corporate income, and

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[2]Prior to amendment in 1982, section 346(b) provided: (b) Termination of a business.—A distribution shall be treated as a distribution described in subsection (a)(2) if the requirements of paragraphs (1) and (2) of this subsection are met.

(1) The distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

(2) Immediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution and was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

Whether or not a distribution meets the requirements of paragraphs (1) and (2) of this subsection shall be determined without regard to whether or not the distribution is pro rata with respect to all of the shareholders of the corporation.

(2) operate under some form of separate supervision and control. *Mains v. United States,* 508 F.2d 1251 (6th Cir. 1975), *cert. denied,* 439 U.S. 981, 99 S.Ct. 569, 58 L.Ed.2d 652 (1978); *Blaschka v. United States,* 393 F.2d 983 (Ct. Cl. 1968); Treas. Reg. §§ 1.346-1(c), 1.355-1(c) (1960). The taxpayers contend that the Tax Court clearly erred in its findings regarding both of these factors.

In light of the income produced from pipeline work and its proportion to the rest of the Company's income as shown by the corporate tax returns presented below, the Tax Court's finding that the evidence failed to show that cross-country pipelining produced a substantial part of the Company's income is questionable. Notwithstanding this questionable finding, the lack of evidence on separate supervision and control provides an independent basis for concluding that no separate trade or business existed. A separate business under section 346(b) includes supervision and control over every integral step and operation which occurs in the production of income and payment of expenses. *See* Treas. Reg. § 1.355-1(c). The Tax Court found that the taxpayers failed to present sufficient evidence to determine if the requisite degree of separate supervision and control had been satisfied. The record does not establish that pipeline activities were subjected to separate accounting or managerial operations which would lend support to the taxpayers' position. The taxpayers have pointed to no evidence in the record on this factor and only argue that completion of expensive pipeline projects in and of itself manifests the presence of separate business control. We agree with the Tax Court that the taxpayers simply failed to carry their burden on this factor. Conse-

quently, we conclude that the record adequately supports the Tax Court's determination that the Company was an integrated operation involving pipeline construction and various other kinds of heavy and highway construction work.

The Tax Court advanced two alternative reasons for its decision. It found that the retention by the Company of some equipment used in pipelining and the fact that all sideboom proceeds were not distributed to Meadows further removed the transactions in question from section 346(b).[3] Inasmuch as the taxpayers failed to meet the threshold requirement of establishing a separate trade or business, their assertions of error with regard to the Tax Court's alternative reasons are inconsequential to the decision. However, it is appropriate to address the taxpayers' position on these alternative reasons for they illustrate the true integration among all of the Company's operations.

To qualify under section 346(b), all of the assets, or proceeds, of a terminated business must be distributed. To hold otherwise would give special tax treatment to something less than termination of a separate business by permitting reinvestment of capital from the terminated business into the remaining business of the corporation. *Gordon v. Commissioner,* 424 F.2d 378, 385-87 (2d Cir.), *cert. denied,* 400 U.S. 848, 91 S.Ct. 63, 27 L.Ed.2d 86 (1970). The taxpayers' argument that retirement of pipeline debts had to

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[3]It is noted that both of these reasons were premised on the taxpayers' assertion that cross-country pipelining was a separate business not only from the Company's other construction work but also from other pipelining operations. We do not find the Tax Court's rejection of this assertion to be clearly erroneous.

precede distribution to Meadows is reasonable. However, the debts which were retired were collaterized not only by the sidebooms but also by other equipment which was retained by the Company. Thus, the distribution was less than complete and the sale of the sidebooms effectively enriched the remaining business. Awarding the taxpayers the benefits of section 346(b) under these circumstances would be contrary to the statutory objective.

With respect to the deductibility of the travel expenses, we find no reversible error.

The judgment of the Tax Court is accordingly,

AFFIRMED.

FILED
JUL 23, 1985
U.S. Court of Appeals
Fourth Circuit

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 84-2283

KENTON MEADOWS COMPANY, INC., etc., et al,
APPELLANTS,

versus

COMMISSIONER OF INTERNAL REVENUE,
APPELLEE.

ORDER

Upon consideration of the appellants' petition for rehearing,

IT IS ORDERED that the petition for rehearing is denied.

Entered at the direction of Judge Ward for a panel consisting of Judge Phillips, Judge Sprouse and Judge Ward, United States District Judge sitting by designation.

For the Court,
John M. Greacen
Clerk

T. C. Memo. 1984-379

UNITED STATES TAX COURT

KENTON MEADOWS COMPANY, INC., A WEST VIRGINIA CORPORATION, KENTON MEADOWS AND ACEL I. MEADOWS, HUSBAND AND WIFE, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 9533-77. Filed July 24, 1984.

David K. Higgins and **David L. Wyant,** for the petitioners.
Robert J. Kastl, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PARKER, *Judge:* By separate statutory notices of deficiency, respondent determined deficiencies in petitioners' Federal income tax as follows:

Taxpayer	Year	Deficiency
Kenton Meadows Company, Inc.	1972	$19,695
	1973	3,051
Kenton Meadows and Acel I. Meadows	1972	64,641
	1973	902

SERVED JUL 24 1984

After numerous concessions by both the corporate and individual petitioners, the issues remaining for decision are: (1) whether a distribution in redemption of a portion of petitioner Kenton Meadows' stock in his wholly-owned corporation, Kenton Meadows Company, Inc. (the Company), was pursuant to a partial liquidation of the Company within the meaning of

section 346(b),[1] so as to receive capital gains treatment, or was a dividend taxable as ordinary income under sections 301 and 316; (2) whether the Company was required to recognize gain on such distribution under section 311(d); (3) whether the Company may deduct as ordinary and necessary business expenses under section 162 payments made to reimburse petitioner Kenton Meadows (Mr. Meadows) for certain foreign travel expenses; and (4) whether the Company's reimbursement of such expenses constituted a constructive dividend to Mr. Meadows.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Kenton Meadows Company, Inc. (hereinafter the Company), was incorporated under the laws of the State of West Virginia. The Company's principal office is located in Gassaway, West Virginia, and was located there when the Company filed its petition herein. The Company filed U.S. Corporation Income Tax Returns, Forms 1120, for the 1972 and 1973 taxable years with the Internal Revenue Service Center in Memphis, Tennessee.

Kenton Meadows and Acel I. Meadows (hereafter Mr. and Mrs. Meadows) were husband and wife and resided in Gassaway, West Virginia when they filed their joint petition along with the Company in this

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[1]Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in issued.

Court. Mr. and Mrs. Meadows filed joint U.S. Individual Income Tax Returns, Forms 1040, for the 1972 and 1973 taxable years with the Internal Revenue Service Center in Memphis, Tennessee. Mr. Meadows was the sole shareholder of all of the issued and outstanding stock of the Company at all times relevant to the issues herein.

Mr. Meadows started in the pipeline and road construction business in approximately 1946 and has been continually engaged in such business since that time. His first corporation apparently was Kenton Meadows Company, Inc. (referred to above and hereafter as the Company), which was incorporated on February 23, 1954 and engaged in heavy and highway construction, including some pipeline construction.

Meadows Southern Construction Company (hereinafter Southern), was incorporated on March 19, 1956. Again Mr. Meadows was the sole shareholder. The business conducted by Southern included construction of roads and bridges.

Elk Valley Land Corporation, another corporation wholly owned by Mr. Meadows, was incorporated on January 6, 1960. This corporation was involved in the business of real estate investment and rentals and also equipment rentals.

Meadows Stone & Paving, Inc. (hereinafter Meadows), was incorporated on October 27, 1961, and its business included asphalt paving and sales of quarried stone and asphaltic concrete. Mr. Meadows was the sole shareholder.

In the mid-1960's, Mr. Meadows purchased all of the issued and outstanding stock of Pipeline Main-

tenance & Construction, Inc. (hereinafter Pipeline), which had been incorporated on February 29, 1956. The business conducted by Pipeline included maintenance and construction of pipelines for the gas industry, with emphasis upon what is known in that industry as "cross-country" gas pipelines.

In cross-country pipelining, the diameter of the pipe exceeds 10 inches (usually 20 to 30 inches) and the length of the pipeline to be constructed spans several miles. The normal contract price for the type of cross-country jobs performed by Pipeline ranged from $500,000 in the early years to $4,000,000 by 1971, and involved a work force of 150 to 700 laborers. Most of Pipeline's customers were major gas companies.

Cross-country pipelining requires some special equipment, in particular, a type of heavy tractor or "pipelayer" with a block and tackle attached to the side, known as a "sideboom." A sideboom is used to raise and lower the heavy, large-diameter pipe in and out of the ditch to perform work thereon, such as welding, and for installation purposes. Caterpillar pipelayer Models 572 and 583 are two types of sidebooms. Sidebooms are not adaptable for use in other types of construction, unless the job requires lifting or lowering something like heavy pipe sections.

During the years prior to its merger with the Company, which will be discussed below, Pipeline did not own the sidebooms it used but rented them from others. The record does not indicate whether Pipeline rented its sidebooms from the Company, from another of Mr. Meadows' corporations, or from third parties. Pipeline did own some equipment on which it claimed depreciation deductions, but the record does not indicate exactly what equipment it owned at the time of the merger.

In addition to the sidebooms, other types of equipment, such as excavating equipment, backhoes, dozers, trucks, winches, and various smaller tools are also used on cross-country pipeline jobs. However, such equipment is multipurpose and could be and was used in other types of construction work.

The Company owned various types of construction equipment, including certain sidebooms. For example in 1968 the Company sold two No. 572 sidebooms and in 1971 it sold a No. 583 that it had acquired in 1969. During its 1969 taxable year, the Company borrowed large sums of money,[2] which it used to purchase various pieces of construction equipment, including five sidebooms, various other types of tractors, excavating equipment, dozers, graders, backhoes, and Mack trucks. Among the sidebooms were one Caterpillar Model No. 572 and three Caterpillar Models No. 583, plus another model which may have been smaller. The equipment thus purchased also served to collateralize the loans. The loans were obtained by the Company and investment tax credits for some of the new equipment were claimed by the Company. The record does not indicate whether any of this equipment was used in the equipment rental business, but it appears that the equipment was jointly used by the Company, Pipeline, Southern, and Meadows, both before and after the merger of these companies.

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[2]The record indicates that a total of $744,000.80 was borrowed by the Company during 1969. Other large amounts were also borrowed in subsequent years.

On January 1, 1970, Pipeline, Southern, and Meadows were all merged into the Company. The reasons underlying the merger were to facilitate the acquisition of performance bonds needed for the various construction contracts and also to simplify audit and the financial statements of the various companies. Pursuant to the mergers, Mr. Meadows received additional stock in the Company in exchange for his stock in Pipeline, Meadows, and Southern.[3] Prior to the mergers, the Company's business had included heavy construction (including both pipeline construction and road construction), general contracting, and equipment rental. Subsequent to the mergers, the Company's business included those same activities in addition to those previously conducted by Pipeline, Meadows, and Southern.

During the early part of 1970, the Company was experiencing difficulty in obtaining performance bonds for several cross-country pipeline jobs upon which it had submitted bids. Because of its large debt obligations incurred to purchase construction equipment and the resulting shortage of cash or other liquid assets, several bonding companies had rejected the Company's application for the required performance bonds, citing insufficient working capital as the reason. The Company then contacted a Mr. Bill Wymer, a bonding agent representing several bonding companies in the United States. Mr. Wymer, along with the bond company he represented in the transaction, recommended to Mr. Meadows that he transfer to the Company certain marketable securities he owned individually, thereby increasing the Com-

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[3]Respondent does not dispute that these mergers were tax-free.

pany's working capital and facilitating acquisition of the necessary performance bonds. Pursuant to this recommendation, Mr. Meadows transferred share certificates representing 80 shares of the Bank of Gassaway to the Company on December 10, 1970,[4] and transferred share certificates representing 70 shares of the Home National Bank of Sutton to the Company on December 25, 1970 (hereinafter collectively referred to as the bank stock). At the time of the transfer of the bank stock, Mr. Meadows had a combined basis in the 150 shares of $84,350. In return for the bank stock, the Company issued share Certificate No. 2, representing 550 shares in the Company, to Mr. Meadows on December 10, 1970. The required performance bonds were obtained by the Company shortly thereafter. At the time of the transfer of the bank stock to the Company and thereafter, Mr. Meadows regarded the bank stock as his and intended that as soon as the need for the stock for bonding purposes passed that the bank stock would be returned to him.

During the latter part of 1971, the demand for cross-country pipeline work declined in the United States, particularly in the eastern part of the country. Upon completion in 1971 of its work under contract, the Company was unable to locate additional cross-country pipeline work in the United States. Accordingly, the Company decided to sell certain sidebooms that were being used only with respect to cross-country pipeline jobs. Since the demand for cross-

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[4]Although the shares were not transferred on the books of the Bank of Gassaway until July 7, 1971, such certificates were signed and dated by Mr. Meadows as of December 10, 1970. However, since the actual date of the transfer to the Company does not affect our decision herein, we will treat such transfer as having occurred on December 10, 1970.

country pipeline construction had essentially dried up in the United States, the sidebooms were sold in Mexico. On January 12, 1972, the Company sold five sidebooms for a total of $182,500. On March 31, 1972, the Company sold two more sidebooms for a total of $55,734. All seven of the sidebooms sold had been purchased by the Company prior to 1970, one in 1967, three in 1968, and three in 1969. All of the sales proceeds were received in cash, which the Company then used to discharge outstanding loan obligations which had been incurred in 1969 to purchase three of these sidebooms and the other construction equipment for the Company's operation.

As the Company no longer required the large performance bonds for the large cross-country pipeline jobs, the bank stock previously transferred to the Company by Mr. Meadows was distributed to him in redemption of the 550 shares of the Company's stock previously received in exchange therefor. The 550 shares of the Company's stock were cancelled. On January 14, 1972, Stock Certificates Nos. 521 and 244 in the name of the Company, representing 70 shares of the Home National Bank of Sutton and 80 shares of the Bank of Gassaway, respectively, were transferred from the Company and into the name of Mr. Meadows, individually. The combined fair market value of the stock when transferred to Mr. Meadows was $107,000.

At no time relevant to the issues in this case was a Form 966, or any document containing the information required by said form, filed by or on behalf of the Company. The Company did not, at any time relevant to the issues in this case, adopt or formulate a written plan or resolution for the liquidation of the whole or any part of its capital stock.

On June 2, 1972, the Company purchased for $52,000 a sideboom similar to the ones sold in January and March of 1972. However, this specific sideboom has never been used by the Company in any sort of pipelining job, instead being rented out to a railroad company for use in righting derailed railroad cars.

KMS, Inc., was incorporated on October 17, 1972. The business of KMS, Inc., includes general construction and equipment rental. The Company was the sole shareholder of all issued and outstanding stock of KMS, Inc. That stock was originally issued to the Company in consideration for the transfer of equipment to KMS, Inc., by the Company. The record does not indicate whether the equipment so transferred included that purchased by the Company in 1969, including the other remaining sideboom.

Since 1972, the Company has not performed any cross-country pipeline work. However, the Company has performed smaller pipelining work, known as "utility" or "station" (hereinafter station) jobs. Such work involves pipes of smaller diameter and shorter distances, requiring less heavy equipment and manpower than cross-country pipeline construction. Such work is known as station work because it is performed close to the utility company's pump stations or compression stations. The Company has performed two station jobs since 1972, one in North Carolina and one in Kentucky.

The Company's capital position over the years was as follows:

Date	Capital Stock	Capital Surplus	Retained Earnings	Total
December 31, 1969 ..	$ 25,000.00	$ 580.00	$ 136,104.00	$ 161,684.00
December 31, 1970 ..	150,000.00	433,330.00	540,253.00	1,123,583.00
December 31, 1971 ..	150,000.00	370,530.00	575,656.00	1,096,186.00

December 31, 1972 ..	95,000.00	341,180.00	558,605.00	994,785.00
December 31, 1973 ..	95,000.00	341,180.00	559,617.00	995,797.00
December 31, 1974 ..	95,000.00	341,180.00	750,713.00	1,186,893.00
December 31, 1975 ..	95,000.00	341,180.00	1,042,002.00	1,478,182.00

In 1972 and 1973, Mr. Meadows took what may best be described as an "around the world" trip, accompanied by Mrs. Meadows and one of their children. A travel agency arranged their travel plans.[5] Among the places visited by Mr. and Mrs. Meadows and their child on this trip were Venezuela, Guatemala, El Salvador, Chile, Brazil, Denmark, Germany, France, and Australia.[6]

Mr. Meadows' stated purpose for this and other trips was to locate new cross-country pipeline construction contracts, since the demand for such work in the United States had drastically declined. Mr. Meadows did obtain a Certificate of Registration of Foreign Company from Australia[7] issued in the Company's name, and also enrolled the Company as a Member of the Australian Pipeline Industry Association. The papers necessary to obtain a similar certificate may have been filed in Venezuela, but, if so,

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[5]Mr. Meadows suggested that this method was cheaper than air fare for direct flight to their destination, but the record does not disclose what their destination was.

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[6]Mr. Meadows could not recall whether or not this trip also included stops in Peru, Colombia, and Jamaica. Mr. Meadows was sure he had visited those countries, but not if he had done so on the specific trip in question herein.

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[7]The Certificate is dated June 23, 1975, long after the taxable years in question herein. Mr. Meadows suggested that the discrepancy was due to delay on the part of the Australian officials. However, we note that Mr. Meadows also stated that there was a delay in commencement of the pipelining business that was expected to get underway in Australia.

the record does not reveal whether a Venezuelan certificate was ever issued.[8]

The Company fully reimbursed Mr. Meadows for all the expenses he and his family incurred on the 1972-1973 trip and deducted such amounts on its 1972 and 1973 corporate income tax returns. The total amount of such reimbursement and corresponding deduction was $15,634 and $1,954 for 1972 and 1973, respectively. Mr. Meadows did not report any part of the reimbursed expenses as income for either 1972 or 1973. There is no evidence in the record substantiating the amounts or nature of the claimed expenditures.

In his notices of deficiency, respondent disallowed the deductions claimed by the Company for those reimbursed travel expenses and treated the reimbursed amounts as constructive dividends to Mr. Meadows. Respondent also increased Mr. Meadows' 1972 income by $107,000, the value of the bank stock transferred to him that year, and increased the Company's income by $22,650, the gain on the transfer of that appreciated bank stock in redemption of the Company's stock.

OPINION

The primary issue in this case is the proper tax treatment of the distribution of the bank stock in redemption of 550 shares of Mr. Meadows' stock in his

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[8]At trial, two documents purporting to give the Company the right to transact business in Venezuela were received into evidence, without objection. However, such documents are entirely in Spanish, and no translation of their contents was offered, although the Court commented on the need therefor.

wholly-owned corporation, the Company.[9] Both the corporate and the individual petitioners contend the distribution of the bank stock was pursuant to a plan of partial liquidation and is therefore treated by section 331(a) (2)[10] as received in exchange for such stock and taxable at capital gains rates, rather than as a dividend taxable as ordinary income. Respondent asserts that the distribution was not pursuant to a partial liquidation, but was instead a redemption treated

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[9]Mr. Meadows testified that he always viewed the bank stock as his own ["mine"] and intended at the time he transferred the bank stock to the Company that the bank stock would be returned to him when it was no longer required to satisfy the bonding needs of the Company. Mr. Meadows may have subjectively viewed the transaction as a loan of his bank stock to his corporation which would not result in any taxable event upon return of the bank stock. That view would be consistent with the fact that he reported no income (neither capital gain nor ordinary income) in connection with the distribution of the bank stock in 1972. Unfortunately, the transaction was not structured that way (perhaps due to the demands of the bonding company), and the Court must deal with the transaction as it was structured. In any event, both parties agree that the Company owned the bank stock once it was contributed to its capital in exchange for additional shares of Company stock and that the later distribution of the bank stock back to Mr. Meadows was a distribution in redemption of 550 shares of stock in the Company.

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[10]During the years in issue, section 331(a)(2) provided that:

> Amounts distributed in partial liquidation of a corporation (as defined in section 346) shall be treated as in part or full payment in exchange for the stock.

Section 331(a) was subsequently amended by section 222(a) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, 96 Stat. 324, 478, which deleted the provisions concerning partial liquidations, applicable generally to distributions after August 31, 1982. See footnote 13, *infra*.

by section 302(d)[11] as a distribution of property subject to the provisions of section 301. Furthermore, respondent asserts that the Company was required to recognize gain on the distribution pursuant to section 311(d) (1).[12] For the reasons stated below, we agree with respondent.

During the years in issue, section 346[13] defined a partial liquidation and provided, in pertinent part, that:

(a) *In General.*—For purposes of this subchapter,

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[11]Section 302(d) provides that:

***Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

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[12]Section 311(d)(1) provides, in part that:

(d) **Appreciated Property Used to Redeem Stock.**—
(1) **In General.**—If—
(A) a corporation distributes property (other than an obligation of such corporation) to a shareholder in a redemption (to which subpart A applies) of part or all of his stock in such corporation, and

(B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),

then a gain shall be recognized to the distributing corporation in an amount equal to such excess as if the property distributed had been sold at the time of the distribution.***

Section 311(d)(2) sets out several exceptions to this general rule, none of which are applicable herein.

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[13]Section 346 was amended by section 222(d) of TEFRA, *supra*, at 479, and the special provisions relating to partial liquidations, as modified to cover only noncorporate shareholders, are now found in section 302(e), added to the Code by section 222(c) (2) of TEFRA, *supra*, at 479, applicable generally to distributions after August 31, 1982.

a distribution shall be treated as an in partial liquidation of a corporation if—

(1) the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan; or

(2) the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year, including (but not limited to) a distribution which meets the requirements of subsection (b).

* * *

(b) *Termination of a Business.*—A distribution shall be treated as a distribution described in subsection (a) (2) if the requirements of paragraphs (1) and (2) of this subsection are met.

(1) The distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

(2) Immediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution and was not acquired by the corporation within such period in a transaction in

> which gain or loss was recognized in whole or in part.
>
> Whether or not a distribution meets the requirements of paragraphs (1) and (2) of this subsection shall be determined without regard to whether or not the distribution is pro rata with respect to all of the shareholders of the corporation.

If a distribution is in partial liquidation of the distributing corporation under the above version of section 346, then those provisions of section 346 take precedence over those of section 302 and the limitations of section 302 are not applicable. Sec. 346 (c); see also sec. 1.346-2, Income Tax Regs.

There is no question that the distribution in this case was not part of a complete redemption of the Company's outstanding stock, and petitioners could not and do not rely on section 346 (a)(1). Petitioners have repeatedly stressed that their argument that the distribution was pursuant to a partial liquidation is based solely on satisfying the requirements of section 346(b)'s "safe harbor," and not on satisfying the more difficult provisions of section 346(a)(2) independently.[14] Thus, the instant transaction must qualify as a partial liquidation under section 346(b) or not

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[14]Section 346(b), by its very terms, merely describes one type of distribution that is automatically treated as "not essentially equivalent to a dividend" within the meaning of section 346(a)(2), thus enabling the taxpayer to assure partial liquidation treatment, provided the other requirements of section 346(a)(2) are met. *Baan v. Commissioner*, 51 T.C. 1032, 1044-1045 (1969), affd. sub nom. *Gordon v. Commissioner*, 424 F. 2d 378 (2d Cir. 1970), affd. per curiam sub nom. *Baan v. Commissioner*, 450 F. 2d 198 (9th Cir. 1971). However, failure to satisfy the requirements of section 346(b) does not preclude a taxpayer from attempting to rely on the separate, but more difficult, requirements of section 346(a)(2). Petitioners have made no attempt to bring themselves within the more general provisions of section 346(a)(2).

at all. Applying section 346(b) to the facts in this case, we think it is clear that the requirements of that section have not been met.

Section 346(b) contains numerous requirements that must be strictly complied with to obtain partial liquidation treatment. We need address only a few of the parties' various arguments to resolve the present dispute.

One of the major requirements of section 346(b) is that the distribution in question be ". . . attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution . . ." Sec. 346(b) (1). We think the distribution herein failed to satisfy this requirement.

The first hurdle petitioners must clear is demonstrating that the Company's cross-country pipeline construction activities constituted a trade or business separate from its other pipeline construction activities, which were admittedly carried on subsequent to the distribution petitioners contend to be a partial liquidation.[15] Section 346(b) itself provides no guid-

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[15]We address this separate trade or business argument in petitioners' own terms of cross-country pipelining construction work versus the Company's other (station) pipelining construction work. However, we are not persuaded that those categories are really two different types of pipelining work, let alone separate trades or businesses. The record shows that Mr. Meadows started in the pipeline and road construction business about 1946 and has been engaged in that business since that time. The Company, from its incorporation in 1954 and before acquisition of Pipeline, was engaged in heavy and highway construction, including some pipeline construction. Pipeline was incorporated in 1956 and Mr. Meadows became its sole shareholder in the mid-1960's. Pipe-

(Footnote continued on next page)

ance in determining whether a group of activities may be said to form a separate trade or business. However, section 1.346-1(c), Income Tax Regs., refers us to section 1.355-1(c), Income Tax Regs., which provides in part that:

> * * * a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses. * * *

The regulations then set out 16 examples which are

(Footnote continued from page 24A)

line's business included maintenance and construction of pipelines, with emphasis on cross-country gas pipelines. However, the record does not indicate how the Company's own pipeline work and/or Pipeline's cross-country pipeline work were carried out either before or after Pipeline's merger with the Company in 1970. There is no evidence to show that cross-country pipelining produced a substantial part of the Company's combined corporate income. There is no evidence of any separation of supervision and control of the purportedly separate cross-country pipelining business. In fact, the record is singularly devoid of any evidence as to the actual operation of the Company's business either before or after the purported partial liquidation. While the petitioners placed much emphasis on the need for sidebooms in the cross-country pipelining work and on the later sale of seven sidebooms, Pipeline itself did not own any sidebooms but rented them before its merger with the Company in 1970. We think it significant that the Company purchased sidebooms in 1967, 1968, and 1969 before the merger of the corporations, and sold sidebooms both before and after the merger. Suffice it to say, the record does not indicate that petitioners at any time treated the two types of pipelining work as separate and distinct businesses, either vis-a-vis each other or vis-a-vis the Company's other construction activities.

intended to illustrate the application of this definition. See sec. 1.355-1(d), Income Tax. Regs. We have found few cases involving the separate trade or business requirement of section 346(b)(1). Guided by the somewhat nebulous definition in the regulations and the examples, the courts have distilled two major factors for a separate trade or business: (1) that the separate business must produce a substantial part of the combined corporate income, and (2) that there must be some form of separation of control and supervision for the separate business. *Mains v. United States,* 508 F. 2d 1251, 1257-1258 (6th Cir. 1975); *Blaschka v. United States,* 184 Ct. Cl. 264, 393 F. 2d 983, 989-992 (1968). As these cases show, merely selling some unwanted or unneeded assets does not constitute a partial liquidation of the corporation. Here, petitioners have not presented sufficient evidence as to the operations of the Company to permit us to determine whether or not the cross-country pipelining activities satisfy these basic requirements for a separate trade or business. See footnote 15.

On the evidence of record, we are not persuaded that the Company's cross-country pipeline activities may properly be regarded as a separate trade or business from its other pipeline activities. Petitioners' attempt to segregate the cross-country pipeline activities from the remaining pipeline activities on the basis of such factors as the diameter of the pipe used, average contract price, need for some special equipment (the sidebooms), and size of the work force used on cross-country jobs is unavailing. On the facts presented, we cannot find that the operations of the Company were anything other than an integrated operation involving various kinds of heavy and highway construction work, including pipeline con-

struction. Looking just at the pipeline work, we think it is more reasonable to view all of the Company's pipeline related activities as constituting only one integrated business. While cross-country pipelining work declined in the United States, petitioner continued to perform station pipelining work after 1972.

However, even assuming the Company's cross-country pipeline activities could properly be viewed as a trade or business separate from its remaining pipeline activities, the transaction in question herein would still not give rise to a partial liquidation within the meaning of section 346(b) for two additional, but related reasons.

Section 1.346-1(b), Income Tax Regs., further explicates the requirements of section 346(b), providing, in part, that:

> A distribution shall be treated as having been made in partial liquidation pursuant to section 346(b) if it consists of the proceeds of the sale of the assets of a trade or business which has been actively conducted for the five-year period and has been terminated, or if it is a distribution in kind of the assets of such a business, or if it is a distribution in kind of some of the assets of such a business and of the proceeds of the sale of the remainder of the assets of such a business. * * *

We have previously construed this language to require that **all** of the assets of the terminated trade or business must be distributed for an in-kind distribution to constitute a distribution in partial liquidation. *Baan v. Commissioner,* 51 T.C. 1032, 1047 (1969), affd. sub nom. *Gordon v. Commissioner,* 424 F. 2d 378 (2d Cir. 1970), affd. per curiam sub nom. *Baan v. Com-*

missioner, 450 F. 2d 198 (9th Cir. 1971). Logic and symmetry, as well as the plain language of the above cited regulation and the legislative history of section 346(b),[16] require the conclusion that if **all** of the assets of the terminated trade or business must be distributed in kind, then **all** of such assets must likewise be sold before a distribution of the proceeds thereof can be considered in partial liquidation. Here, the Company sold only the seven sidebooms which had been used for cross-country pipelining work. Since the Company, rather than Pipeline, had bought those sidebooms in 1967, 1968, and 1969, before the Pipeline's merger with the Company in 1970, we have some difficulty linking those sidebooms solely to Pipeline's cross-country pipelining work. The sidebooms may well have been part of the Company's separate equipment rental business, which was never terminated.[17] In any event, any contention that these seven sidebooms represented **all** of the assets used in the

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[16]The Senate Report, speaking of section 346(b), states:

> Under this rule, if a corporation is engaged in two or more active businesses which has [sic] been carried on for at least 5 years, it may distribute **the** assets of either one of the businesses in kind, or **the** proceeds of **their** sale. [Emphasis added.]

(S. Rept. No. 1622, 83d Cong., 2d Sess., 49 (1954)).

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[17]When work became available such as the railroad car work, the Company bought another sideboom in 1972 and rented it to the railroad company. Had cross-country pipelining work again become available, the Company no doubt could have purchased more sidebooms to do the work or could have rented them just as Pipeline had done before it merged with the Company. Thus, we cannot accord to the sale of the sidebooms the significance that petitioners attach to that fact. The sale of the sidebooms can be viewed as a sale of equipment that is no longer needed, rather than as a termination of a separate trade or business. The Company bought and sold sidebooms before Pipeline ever merged with it.

Company's cross-country pipeline activities would be incredulous. The record clearly reveals that the Company also owned numerous pieces of general construction equipment such as backhoes, excavating equipment, trucks, winches, and various hand tools. That equipment was used in the Company's cross-country pipeline activities as well as in its other construction activities, and none of these assets were sold. Such assets were readily usable in the Company's other construction activities and were retained and used therein. We do not think that the sale of assets which occurred in this case is of the type contemplated by section 346(b).

Furthermore, no part of the proceeds from the sale of the sidebooms was distributed. Instead, only the bank stock which had previously been transferred to the Company by Mr. Meadows was distributed. See footnote 9. We have previously held that section 346(b) requires that all of the proceeds of sale must be distributed. *Baan v. Commissioner, supra,* 51 T.C. at 1047. In *Baan, supra,* at 1047, we said that:

> This interpretation serves the purpose of the section: if all the proceeds of the transfer of an active business are not distributed to the shareholders, the shareholders would still have an interest in the transferred business inherent in their stock in the transferor, and the rationale for giving a distribution capital gains treatment would not be present.

In affirming our conclusion on this point, the Second Circuit said:

> This holding draws support not only from linguistic inference but also from policy. Where a

corporation ceases to conduct a discrete portion of its business and distributes the entire assets of this separate portion or the proceeds thereof to the shareholders, Congress has provided that the distribution be treated not as a return of profits but as a return to the shareholders of part of the capital which they had committed to the original venture. If all the actual capital assets of the business or all the proceeds thereof received by the business from a disposition of those assets are being distributed this treatment is an eminently logical one. However, between this situation and the hypothetical case where the corporation distributes only a small portion of the assets or the proceeds of their sale, Section 346 draws no line apparent to this court. It seems reasonably clear, moreover, that the hypothetical case just mentioned is not one which deserves to be called a partial liquidation. Indeed, it constitutes nothing more than a reinvestment in another line of business of most of the capital that was used in the terminated business, with the result that there occurs relatively little contraction in the size of the activities of the corporation as a whole. Because the intellectual concept of a partial liquidation is itself a tenuous one and difficult to separate, except by intuition, from the concept of a distribution of profits, **we feel compelled to grasp the only certain standard of differentiation which we can see and to require that all the assets of a liquidated business, or all the proceeds thereof, be distributed before the transaction qualified under Section 346(b).** * * * [Emphasis added.]

Gordon v. Commissioner, supra, 424 F. 2d at 386-387. Clearly the requirement that all of the proceeds be distributed has not been met, since **no** proceeds of the sale of assets were distributed.

Petitioners counter by asserting that respondent's rulings indicate it is sufficient if only the "net proceeds" from the sale are distributed. See Rev. Rul. 60-232, 1960-2 C.B. 115; Rev. Rul. 75-3, 1975-1 C.B. 108; and Rev. Rul. 76-289, 1976-2 C.B. 100. Petitioners then assert that they have met this standard, contending that since the full amount of the sales proceeds was used to extinguish outstanding debts of the Company, no net proceeds remained to be distributed.

Petitioners' contention is inapposite. Initially, the rulings upon which they rely are more properly interpreted as defining only the maximum amount (net proceeds of sale plus allocable portion of working capital) which may be distributed under section 346(b) rather than defining the minimum amount required to be distributed. This is clearly indicated by the language in these rulings allowing a distribution of that portion of the working capital reasonably attributable to the terminated business **in addition to** the net proceeds from the sale of such business assets. Further, even assuming petitioners' contention is correct that only the net proceeds from the sale must be distributed, we do not think the term "net proceeds" can be interpreted so broadly as to cover the transaction herein. Besides the fact that only the bank stock (arguably the allocable portion of working capital) was distributed here, no portion of the proceeds from the sale of asets was distributed. The record establishes that some of the debts which were extinguished with the sales proceeds were collateralized

not only by the sidebooms which were sold, but also by various other pieces of equipment used in the Company's other construction activities. Indeed, the record fails to indicate that any such debts were collateralized solely by the sidebooms. To define the term "net proceeds" broadly enough to countenance such a transaction would violate what this Court and the Second Circuit have identified as the purpose underlying the requirement that all of the proceeds be distributed: to prevent a reinvestment of the capital used in the terminated business in another line of the corporation's remaining business, thereby retaining the shareholder's interest in the transferred business which is inherent in his stock in the transferor. See *Baan v. Commissioner, supra,* 51 T.C. at 1047; *Gordon v. Commissioner, supra,* 424 F. 2d at 386.

Thus, for the above stated reasons, we think it is clear that the transaction herein did not constitute a partial liquidation within the meaning of section 346(b).[18] Therefore, the redemption of Mr. Meadows' stock is treated as a distribution of property subject to the provisions of section 301, and therefore a dividend to the extent of the Company's current and accumulated earnings and profits. Secs. 302(d) and 316. There were ample earnings and profits so the entire $107,000 is a dividend taxable as ordinary income, as respondent determined.

This brings us to the related issue of whether the

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[18]We note that both parties spent a great deal of time briefing the issue of whether the distribution was pursuant to a "plan" of partial liquidation, section 346(a)(2), since no Form 966 or other written evidence of such a plan was extant herein. Due to our resolution of other issues herein, we need not reach this issue. See, however, *Fowler Hosiery Co. v. Commissioner,* 36 T.C. 201 (1961), affd. 301 F. 2d 394 (7th Cir. 1962). Here, there are no facts indicating the existence of any plan.

Company was required to recognize gain on the distribution. Petitioners presented no evidence on this point, nor did they raise any arguments in respect thereto at trial or on brief. Thus, this issue can be disposed of in respondent's favor on the separate grounds of either a concession by petitioners or a failure to carry their burden of proof or to adduce any evidence. Rules 142(a) and 149(b), Tax Court Rules of Practice and Procedure. In any event, disposition of this issue in respondent's favor is also mandated by the clear terms of section 311(d)(1). Therefore, the Company must recognize a gain on the distribution equal to the excess of the fair market value of the distributed property over its adjusted basis to the Company, the same as if such property had been sold on the date of the distribution. That amounts to a gain of $22,650 in this case.

The remaining issues concern whether the Company may deduct its reimbursement of Mr. Meadows' foreign travel expenses as an ordinary and necessary business expense under section 162, and also whether such reimbursement constitutes a constructive dividend to Mr. Meadows.[19] For the reasons stated hereinafter, we agree with respondent that such amount is not deductible by the Company and is a constructive dividend to Mr. Meadows.

Section 162(a) allows a deduction for all ordinary

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[19]Petitioners have conceded that the portion of such expenses attributable to Mrs. Meadows and the child is both nondeductible by the Company and gives rise to a constructive dividend to Mr. Meadows. However, there is no basis in the record for making any allocation. The Court does not accept Mr. Meadows' self-serving statement that 60 percent of the expenses related to his activities for the Company and only 40 percent related to his wife and child.

and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. The question is essentially factual. *Commissioner v. Heininger,* 320 U.S. 467, 475 (1943); *Walliser v. Commissioner,* 72 T.C. 433, 437 (1979); *Henry v. Commissioner,* 36 T.C. 879, 883 (1961). The Company must show that the expenses claimed were incurred primarily for business rather than personal or social reasons and that there is a proximate relation between the costs of the trip and the Company's business. *Henry v. Commissioner, supra,* 36 T.C. at 884; *Larrabee v. Commissioner,* 33 T.C. 838, 841 (1960). These same principles apply to corporate taxpayers as well as individual taxpayers. *International Trading Co. v. Commissioner,* 275 F. 2d 578 (7th Cir. 1960), affg. a Memorandum Opinion of this Court; *International Artists, Ltd. v. Commissioner,* 55 T.C. 94, 104-105 (1970). The taxpayer has the burden of proof, *Welch v. Helvering,* 290 U.S. 111 (1933); Rule 142(a). Here petitioners have not carried their burden.

The evidence presented at trial consisted in large part of the virtually uncorroborated, self-serving testimony of Mr. Meadows, the Company's sole shareholder. Mr. Meadows testified that this "around the world" trip in 1972 and 1973 was for the purpose of seeking out cross-country pipelining work for the Company, the very type of business that petitioners asserted had been terminated by the Company in early 1972. The scant documentary evidence presented, part of which was entirely in Spanish with no translation made available, is simply insufficient to persuade us that the primary reason underlying such trip was business related, rather than personal. No evidence was presented as to how much time was spent in

performing business-related activities or in obtaining such documents, which for aught that appears in the record could have been miniscule. Furthermore, the only evidence presented to explain why the trip took the form of an around the world trip with his wife and child, as opposed to a direct flight, was Mr. Meadows' undocumented testimony that the method chosen was the less expensive one. On the record herein, we cannot say that the Company has carried its burden of showing that the travel expenses are deductible under section 162. Since the trip expenses are not deductible under section 162, we need not address the issue of whether the requirements of section 274 have been met, but it is clear they have not.

Since payments of the travel expenses were not properly deductible by the Company under section 162, and no evidence was presented at trial to show that Mr. Meadows derived no benefit from such payments,[20] the individual petitioners have failed to carry their burden of proving that such amounts did not represent constructive dividends, as determined by respondent. *Welch v. Helvering, supra*; Rule 142(a), Tax Court Rules of Practice and Procedure. Accordingly, respondent is sustained on this issue.

Decision will be entered for the respondent.

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[20]Cf. *Foster v. Commissioner*, 80 T.C. 34 (1983); *Ashby v. Commissioner*, 50 T.C. 409, 417-418 (1968). As to the travel expenses for Mrs. Meadows and their child, Mr. Meadows clearly derived a personal benefit and has so conceded. As to his own travel expenses, Mr. Meadows failed to show that he received no benefit, and we think it is clear that he received the benefits of a vacation trip.

UNITED STATES TAX COURT
Washington

KENTON MEADOWS COMPANY, INC., A WEST VIRGINIA CORPORATION, KENTON MEADOWS AND ACEL I. MEADOWS, HUSBAND AND WIFE,

Petitioners

v. Docket No. 9533-77

COMMISSIONER OF INTERNAL REVENUE,

Respondent

DECISION

Pursuant to the determination of the Court, as set forth in its T.C. Memo. 1984-379, filed July 24, 1984, it is

ORDERED AND DECIDED that there are deficiencies in petitioners' Federal income tax for the years and amounts as follows:

Taxpayer	**Year**	**Deficiency**
Kenton Meadows Company, Inc.	1972	$19,695
	1973	3,051
Kenton Meadows and Acel I. Meadows	1972	64,641
	1973	902

Edna G. Parker
Judge

ENTERED: JUL 25 1984

SERVED JUL 25 1984

26 U.S.C. §301 Distributions of Property:

(a) In General. Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

(b) Amount distributed. (1) General rule. For purposes of this section, the amount of any distribution shall be—

(A) Noncorporate distributees. If the shareholder is not a corporation, the amount of money received, plus the fair market value of the other property received.

(B) Corporate distributees. If the shareholder is a corporation, unless subparagraph (D) applies, the amount of money received, plus whichever of the following is the lesser:

(i) the fair market value of the other property received; or

(ii) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of the other property received, increased in the amount of gain recognized to the distributing corporation on the distribution.

(C) Certain corporate distributees of foreign corporation. Notwithstanding subparagraph (B), if the shareholder is a corporation and the distributing corporation is a foreign corporation, the amount taken into account with respect to property (other than money) shall be the fair market value of such property; except that if any deduction is allowable under section 245 with respect to such distribution, then the amount taken into account shall be the sum (determined under regulations prescribed by the Secretary) of—

(i) the proportion of the adjusted basis of such property (or, if lower, its fair market value) properly attributable to gross income which is effectively connected with the conduct of a trade or business within the United States and

(ii) the proportion of the fair market value of such property properly attributable to gross income which is not effectively connected with the conduct of a trade or business within the United States.

For purposes of clause (i), the gross income of a foreign corporation for any period before its first taxable year beginning after December 31, 1966, which is effectively connected with the conduct of a trade or business within the United States is an amount equal to the gross income for such period from sources within the United States. For purposes of clause (ii), the gross income of a foreign corporation for any period before its first taxable year beginning after December 31, 1966, which is not effectively connected with the conduct of a trade or business within the United States is an amount equal to the gross income for such period from sources without the United States.

(D) Foreign corporate distributees. In the case of a distribution to a shareholder which is a foreign corporation, if the amount received by the foreign corporation is not effectively connected with the conduct by it of a trade or business within the United States, the amount of the money received, plus the fair market value of the other property received.

(2) Reduction for liabilities. The amount of any distribution determined under paragraph (1) shall be reduced (but not below zero) by—

(A) the amount of any liability of the corporation

assumed by the shareholder in connection with the distribution, and

(B) the amount of any liability to which the property received by the shareholder is subject immediately before, and immediately after, the distribution.

(3) Determination of fair market value. For purposes of this section, fair market value shall be determined as of the date of the distribution.

(c) Amount taxable. In the case of a distribution to which subsection (a) applies—

(1) Amount constituting dividend. That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) Amount applied against basis. That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) Amount in excess of basis.

(A) In general. Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) Distributions out of increase in value accrued before March 1, 1913. That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

(d) Basis. The basis of property received in a distribution to which subsection (a) applies shall be—

(1) Noncorporate distributees. If the shareholder is

not a corporation, the fair market value of such property.

(2) Corporate distributees. If the shareholder is a corporation, unless paragraph (3) applies, whichever of the following is the lesser:

(A) the fair market value of such property; or

(B) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property, increased in the amount of gain recognized to the distributing corporation on the distribution.

(3) Foreign corporate distributees. In the case of a distribution of property to a shareholder which is a foreign corporation, if the amount received by the foreign corporation is not effectively connected with the conduct by it of a trade or business within the United States, the fair market value of the property received.

(4) Certain corporate distributees of foreign corporation. In the case of property described in subparagraph (C) of subsection (b)(1), the basis shall be determined by substituting the amount determined under such subparagraph (C) for the amount described in paragraph (2) of this subsection.

(e) Special rule for holding period of appreciated property distributed to corporation. For purposes of this subtitle—

(1) Where gain recognized under section 311(d). If—

(A) property is distributed to a corporation, and

(B) gain is recognized on such distribution under paragraph (1) of section 311(d),

then such corporation's holding period in the dis-

tributed property shall begin on the date of such distribution.

(2) Where gain not recognized under section 311(d) [26 USCS §311(d)]. If—

(A) property is distributed to a corporation,

(B) gain is not recognized on such distribution under paragraph (1) of section 311(d) [26 USCS §311(d)], and

(C) the basis of such property in the hands of such corporation is determined under subsection (d)(2)(B), then (except for purposes of section 1248) such corporation shall not be treated as holding the distributed property during any period before the date on which such corporation's holding period in the stock began.

(f) Special rule for certain distributions received by 20 percent corporate shareholder. (1) In general. Except to the extent otherwise provided in regulations, solely for purposes of determining the taxable income of any 20 percent corporate shareholder (and its adjusted basis in the stock of the distributing corporation), section 312 shall be applied with respect to the distributing corporation as if it did not contain subsection (n) thereof.

(2) 20 percent corporate shareholder. For purposes of this subsection, the term "20 percent corporate shareholder" means, with respect to any distribution, any corporation which owns (directly or through the application of section 318)—

(A) stock in the corporation making the distribution possessing at least 20 percent of the total combined voting power of all classes of stock entitled to vote, or

(B) at least 20 percent of the total value of all stock of the distributing corporation (except nonvoting stock which is limited and preferred as to dividends), but only if, but for this subsection, the distributee corporation would be entitled to a deduction under section 243, 244, or 245 with respect to such distribution.

(3) regulations. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.

(g) Special rules. (1) For distributions in redemption of stock, see section 302.

(2) For distributions in complete liquidation, see part II (sec. 331 and following).

(3) For distributions in corporate organizations and reorganizations, see part III, (sec. 351 and following).

(4) For partial exclusion from gross income of dividends received by individuals, see section 116.

26 U.S.C. §302. Distributions in redemption of stock:

(a) General rule. If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) or subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) Redemptions treated as exchanges. (1) Redemptions are not equivalent to dividends. Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) Substantially disproportionate redemption of stock. (A) In general. Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) Limitation. This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) Definitions. For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio with the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time, is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) Series of redemptions. This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) Termination of shareholder's interest. Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(4) Redemption from noncorporate shareholder in

partial liquidation. Subsection (a) shall apply to a distribution if such distribution is—

(A) in redemption of stock held by a shareholder who is not a corporation, and

(B) in partial liquidation of the distributing corporation.

(5) Application of paragraphs. In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account. If a redemption meets the requirements of paragraph (3) and also the requirements of paragraph (1), (2), or (4), then so much of subsection (c)(2) as would (but for this sentence) apply in respect of the acquisition of an interest in the corporation within the 10-year period beginning on the date of the distribution shall not apply.

(c) Constructive ownership of stock. (1) In general. Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section.

(2) For determining termination of interest. (A) In the case of a distribution described in subsection (b)(3), section 318(a)(1) shall not apply if—

(i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor,

(ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and

(iii) the distributee, at such time and in such manner as the Secretary by regulations prescribes, files an

agreement to notify the Secretary of any acquisition described in clause (ii) and to retain such records as may be necessary for the application of this paragraph.

If the distributee acquires such an interest in the corporation (other than by bequest or inheritance) within 10 years from the date of the distribution, then the periods of limitation provided in sections 6501 and 6502 on the making of an assessment and the collection by levy or a proceeding in court shall, with respect to any deficiency (including interest and additions to the tax) resulting from such acquisition, include one year immediately following the date on which the distributee (in accordance with regulations prescribed by the Secretary) notifies the Secretary of such acquisition; and such assessment and collection may be made notwithstanding any provision of law or rule of law which otherwise would prevent such assessment and collection.

(B) Subparagraph (A) of this paragraph shall not apply if—

(i) any portion of the stock redeemed was acquired, directly or indirectly, within the 10-year period ending on the date of the distribution by the distributee from a person the ownership of whose stock would (at the time of distribution) be attributable to the distributee under section 318(a), or

(ii) any person owns (at the time of the distribution) stock the ownership of which is attributable to the distributee under section 318(a) and such person acquired any stock in the corporation, directly or indirectly, from the distributee within the 10-year period ending on the date of the distribution, unless

such stock so acquired from the distributee is redeemed in the same transaction.

The preceding sentence shall not apply if the acquisition (or, in the case of clause (ii), the disposition) by the distributee did not have as one of its principal purposes the avoidance of Federal income tax.

(C) Special Rule for waivers by entities. (i) In general. Subparagraph (A) shall not apply to a distribution to any entity unless—

(I) such entity and each related person meet the requirements of clauses (i), (ii), and (iii) of subparagraph (A), and

(II) each related person agrees to be jointly and severally liable for any deficiency (including interest and additions to tax) resulting from an acquisition described in clause (ii) of subparagraph (A).

In any case to which the preceding sentence applies, the second sentence of subparagraph (A) and subparagraph (B)(ii) shall be applied by substituting "distributee or any related person" for "distributee" each place it appears.

(iii) Definitions. For purposes of this subparagraph—

(I) the term "entity" means a partnership, estate, trust, or corporation; and

(II) the term "related person" means any person to whom ownership of stock in the corporation is (at the time of the distribution) attributable under section 318(a)(1) if such stock is further attributable to the entity under section 318(a)(3).

(d) Redemptions treated as distributions of property. Except as otherwise provided in this subchapter [26 USCS §§301 et seq.], if a corporation redeems its stock (within the meaning of section 317(b), and if

subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

(e) Partial liquidation defined. (1) In general. For purposes of subsection (b)(4), a distribution shall be treated as in partial liquidation of a corporation if—

(A) the distribution is not essentially equivalent to a dividend (determined at the corporate level rather than at the shareholder level), and

(B) the distribution is pursuant to a plan and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year.

(2) Termination of business. The distributions which meet the requirements of paragraph (1)(A) shall include (but shall not be limited to) a distribution which meets the requirements of subparagraphs (A) and (B) of this paragraph:

(A) The distribution is attributable to the distributing corporation's ceasing to conduct, or consists of the assets of, a qualified trade or business.

(B) Immediately after the distribution, the distributing corporation is actively engaged in the conduct of a qualified trade or business.

(3) Qualified trade or business. For purposes of paragraph (2), the term "qualified trade or business" means any trade or business which—

(A) was actively conducted throughout the 5-year period ending on the date of the redemption, and

(B) was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

(4) Redemption may be pro rata. Whether or not a redemption meets the requirements of subparagraphs (A) and (B) of paragraph (2) shall be determined with-

out regard to whether or not the redemption is pro rata with respect to all of the shareholders of the corporation.

(5) Treatement of certain pass-thru entities. For purposes of determining under subsection (b)(4) whether any stock is held by a shareholder who is not a corporation, any stock held by a partnership, estate, or trust shall be treated as if it were actually held proportionately by its partners or beneficiaries.

(f) Cross references. For special rules relating to redemption—

(1) Death Taxes. Of stock to pay death taxes, see section 303.

(2) Section 306 Stock. Of section 306 stock, see section 306 [26 USCS §306].

(3) Liquidations. Of stock in complete liquidation, see section 331.

26 U.S.C. §311. Taxability of Corporation on Distribution

(a) General rule. Except as provided in subsections (b), (c), and (d) of this section and section 453B, no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of—

(1) its stock (or rights to acquire its stock), or

(2) property.

(b) LIFO inventory. (1) Recognition of gain. If a corporation inventorying goods under the method provided in section 472 (relating to last-in, first-out inventories) distributes inventory assets (as defined in paragraph (2) (A)), then the amount (if any) by which—

(A) the inventory amount (as defined in paragraph

(2)(B) of such assets under a method authorized by section 471 (relating to general rule for inventories), exceeds

(B) the inventory amount of such assets under the method provided in section 472,

shall be treated as gain to the corporation recognized from the sale of such inventory assets.

(2) Definitions. For purposes of paragraph (1)—

(A) Inventory assets. The term "inventory assets" means stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year.

(B) Inventory amount. The term "inventory amount" means, in the case of inventory assets distributed during a taxable year, the amount of such inventory assets determined as if the taxable year closed at the time of such distribution.

(3) Method of determining inventory amount. For purposes of this subsection, the inventory amount of assets under a method authorized by section 471 shall be determined—

(A) if the corporation uses the retail method of valuing inventories under section 472, by using such method, or

(B) if subparagraph (A) does not apply, by using cost or market, whichever is lower.

(c) Liability in excess of basis. If—

(1) a corporation distributes property to a shareholder with respect to its stock,

(2) such property is subject to a liability, or the shareholder assumes a liability of the corporation in connection with the distribution, and

(3) the amount of such liability exceeds the ad-

justed basis (in the hands of the distributing corporation) of such property,
then gain shall be recognized to the distributing corporation in an amount equal to such excess as if the property distributed had been sold at the time of the distribution. In the case of a distribution of property subject to a liability which is not assumed by the shareholder, the amount of gain to be recognized under the preceding sentence shall not exceed the excess, if any, of the fair market value of such property over its adjusted basis.

(d) Distributions of appreciated property. (1) In general. If—

(A) a corporation distributes property (other than an obligation of such corporation) to a shareholder in a distribution to which subpart A applies, and

(B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),

then gain shall be recognized to the distributing corporation in an amount equal to such excess as if the property distributed had been sold at the time of the distribution. This subsection shall be applied after the application of subsections (b) and (c).

(2) Exceptions and limitations. Paragraph (1) shall not apply to—

(A) a distribution which is made with respect to qualified stock if—

(i) section 302(b)(4) applies to such distribution, or

(ii) such distribution is a qualified dividend;

(B) a distribution of stock or an obligation of a corporation if the requirements of paragraph (2) of subsection (e) are met with respect to the distribution;

(C) a distribution to the extent that section 303(a)

(relating to distributions in redemption of stock to pay death taxes) applies to such distribution;

(D) a distribution to a private foundation in redemption of stock which is described in section 537(b)(2) (A) and (B); and

(E) a distribution by a corporation to which part I of subchapter M (relating to regulated investment companies) applies, if such distribution is in redemption of its stock upon the demand of the shareholder.

[(F) Redesignated]

(e) Definitions and special rules for subsection (d)(2). For purposes of subsection (d)(2) and this subsection—

(1) Qualified stock. (A) In general. The term "qualified stock" means stock held by a person (other than a corporation who at all times during the lesser of—

(i) the 5-year period ending on the date of distribution, or

(ii) the period during which the distributing corporation (or a predecessor corporation) was in existence,

held at least 10 percent in value of the outstanding stock of the distributing corporation (or predecessor corporation).

(B) Determination of stock held. Section 318 [26 USCS §318] shall apply in determining ownership of stock under subparagraph (A); except that, in applying section 318(a)(1), the term "family" includes any individual described in section 267(c)(4) and any spouse of any such individual.

(C) Rules for passthru entities. In the case of an S corporation, partnership, trust, or estate—

(i) the determination of whether subparagraph (A)

is satisfied shall be made at the shareholder, partner, or beneficiary level (rather than at the entity level), and

(ii) the distribution shall be treated as made directly to the shareholders, partners, or beneficiaries in proportion to their respective interests in the entity.

(2) Distributions of stock or obligations of controlled corporations. (A) Requirements. A distribution of stock or an obligation of a corporation (hereinafter in this paragraph referred to as the "controlled corporation") meets the requirements of this paragraph if—

(i) such distribution is made with respect to qualified stock,

(ii) substantially all of the assets of the controlled corporation consists of the assets of 1 or more qualified businesses,

(iii) no substantial part of the controlled corporation's nonbusiness assets were acquired from the distributing corporation, in a transaction to which section 351 applied or as a contribution to capital, within the 5-year period ending on the date of the distribution, and (iv) more than 50 percent in value of the outstanding stock of the controlled corporation is distributed by the distributing corporation with respect to qualified stock.

(B) Definitions. For purposes of subparagraph (A)—

(i) Qualified business. The term "qualified business" means any trade or business which—

(I) was actively conducted throughout the 5-year period ending on the date of the distribution, and

(II) was not acquired by any person within such period in a transaction in which gain or loss was recognized in whole or in part.

(ii) Nonbusiness asset. The term "nonbusiness asset" means any asset not used in the active conduct of a trade or business.

(3) Qualified dividend. The term "qualified dividend" means any distribution of property to a shareholder other than a corporation if—

(A) such distribution is a dividend,

(B) such property was used by the distributing corporation in the active conduct of a qualified business (as defined in paragraph (2)), and

(C) such property is not property described in paragraph (1) or (4) of section 1221.

26 U.S.C. §346. Definition and special rule:

(a) Complete liquidation. For purposes of this subchapter, a distribution shall be treated as in complete liquidation of a corporation if the distribution is one of a series of distributions in redemption of all the stock of the corporation pursuant to a plan.

(b) Transactions which might reach same result as partial liquidations. The Secretary shall prescribe such regulations as may be necessary to ensure that the purposes of subsections (a) and (b) of section 222 of the Tax Equity and Fiscal Responsibility Act of 1982 (which repeal the special tax treatment for partial liquidations) may not be circumvented through the use of section 355, 351, 337, or any other provision of law or regulations (including the consolidated return regulations).

26 U.S.C. §355. Distribution of stock and securities of a controlled corporation:

(a) Effect on distributees. (1) General rule. If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax, then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) Non pro rata distributions, etc. Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan or reorganization (within the meaning of section 368(a)(1)(D).

(3) Limitations. (A) Excess principal amount. Paragraph (1) shall not apply if—

(i) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(ii) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

(B) Stock acquired in taxable transactions within 5 years treated as boot. For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction—

(i) which occurs within 5 years of the distribution of such stock, and

(ii) in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(C) Property attributable to accrued interest. Neither paragraph (1) nor so much of section 356 as relates to paragraph (1) shall apply to the extent that any stock, securities, or other property received is attributable to interest which has accrued on securi-

ties on or after the beginning of the holder's holding period.

(4) Cross references. (A) For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered, but not including property to which paragraph (3)(C) applies), see section 356.

(B) For treatment of accrued interest in the case of an exchange described in paragraph (3)(C), see section 61.

(b) Requirements as to active business. (1) In general. Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporatons is engaged immediately after the distribution in the active conduct of a trade or business.

(2) Definition. For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively con-

ducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporatons) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

26 C.F.R. §1.346-1 Partial liquidation:

(a) General. This section defines a partial liquidation. If amounts are distributed in partial liquidation such amounts are treated under section 331(a)(2) as received in part or full payment in exchange for the stock. A distribution is treated as in partial liquidation of a corporation if:

(1) The distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan of complete liquidation, or

(2) The distribution:

(i) Is not essentially equivalent to a dividend,

(ii) Is in redemption of a part of the stock of the corporation pursuant to a plan, and

(iii) Occurs within the taxable year in which the plan is adopted or within the succeeding taxable year.

An example of a distribution which will qualify as a partial liquidation under subparagraph (2) of this paragraph and section 346(a) is a distribution resulting from a genuine contraction of the corporate business such as the distribution of unused insurance proceeds recovered as a result of a fire which destroyed part of the business causing a cessation of a part of its activities. On the other hand, the distribution of funds attributable to a reserve for an expansion program which has been abandoned does not qualify as a partial liquidation within the meaning of section 346(a). A distribution to which section 355 applies (or so much of section 356 as relates to section 355) is not a distribution in partial liquidation within the meaning of section 346(a).

(b) Special requirements of termination on business. A distribution which occurs within the taxable year in which the plan is adopted or within the succeeding taxable year and which meets the requirements of subsection (b) of section 346 falls within paragraph (a)(2) of this section and within section 346(a)(2). The requirements which a distribution must meet to fall within subsection (b) of section 346 are:

(1) Such distribution is attributable to the corporation's ceasing to conduct, or consists of assets of, a trade or business which has been actively conducted throughout the five-year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part, and

(2) Immediately after such distribution by the corporation it is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the five-year period ending on the date of such distribution and was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

A distribution shall be treated as having been made in partial liquidation pursuant to section 346(b) if it consists of the proceeds of the sale of the assets of a trade or business which has been actively conducted for the five-year period and has been terminated, or if it is a distribution in kind of the assets of such a business, or if it is a distribution in kind of some of the assets of such a business and of the proceeds of the sale of the remainder of the assets of such a business. In general, a distribution which will qualify under section 346(b) may consist of, but is not limited to:

(i) Assets (other than inventory or property described in subdivision (ii) of this subparagraph) used in the trade or business throughout the five-year period immediately before the distribution (for this purpose an asset shall be considered used in the trade or business during the period of time the asset which it replaced was so used), or

(ii) Proceeds from the sale of assets described in subdivision (i) of this subparagraph, and, in addition,

(iii) The inventory of such trade or business or property held primarily for sale to customers in the ordinary course of business, if:

(a) The items constituting such inventory or such property were substantially similar to the items con-

stituting such inventory or property during the five-year period immediately before the distribution, and

(b) The quantity of such items on the date of distribution was not substantially in excess of the quantity of similar items regularly on hand in the conduct of such business during such five-year period, or

(iv) Proceeds from the sale of inventory or property described in subdivision (iii) of this subparagrph, if such inventory or property is sold in bulk in the course of termination of such trade or business and if with respect to such inventory the conditions of subdivision (iii) (a) and (b) of this subparagraph would have been met had such inventory or property been distributed on the date of such sale.

(c) Active conduct of a trade or business. For the purpose of section 346(b)(1), a corporation shall be deemed to have actively conducted a trade or business immediately before the distribution, if:

(1) In the case of a business the assets of which have been distributed in kind, the business was operated by such corporaton until the date of distribution, or

(2) In the case of a business the proceeds of the sale of the assets of which are distributed, such business was actively conducted until the date of sale and the proceeds of such sale were distributed as soon thereafter as reasonably possible.

The term "active conduct of a trade or business" shall have the same meaning in this section as in paragraph (c) of §1.355-1.

26 C.F.R. §1.355-1 Distribution of stock and securities of controlled corporation:

(a) Application of section. Section 355 provides for the separation, without recognition of gain or loss to

the shareholders and security holders, of two or more existing businesses formerly operated, directly or indirectly, by a single corporation. It applies only to the separation of existing businesses which have been in active operation for at least five years, and which, in general, have been owned for at least five years by the corporation making the distribution of stock or of stock and securities. Section 355 does not apply to the division of a single business. For the purpose of section 355, stock rights or stock warrants are not included in the term "stock and securities".

(b) Types of separations. Section 355 is concerned with two general types of separations of businesses. The first is the distribution of the stock of an existing corporation. The second is the distribution of the stock of a new corporation which stock was received in exchange for the assets of a business previously operated by the distributing corporation. In both cases, this section contemplates the continued operation of the businesses existing prior to the separation.

(c) Active business. Section 355 is not applicable unless the controlled corporation and the distributing corporation are each engaged in the active conduct of a trade or business. For specific rules in this connection see section 355(b) (1) and (2). Without regard to such rules, for purposes of section 355, a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the

collection of income and the payment of expenses. It does not include—

(1) The holding for investment purposes of stock, securities, land or other property, including casual sales thereof (whether or not the proceeds of such sales are reinvested),

(2) The ownership and operation of land or buildings all or substantially all of which are used and occupied by the owner in the operation of a trade or business, or

(3) A group of activities which, while a part of a business operated for profit, are not themselves independently producing income even though such activities would produce income with the addition of other activities or with large increases in activities previously incidental or insubstantial.

(d) Examples. The following examples illustrate the application of the rules described in paragraph (c) of this section:

Example (1). Corporation A is engaged in the manufacture and sale of soap and detergents and owns investment securities. It proposes to place the investment securities in a new corporation and distribute the stock of such new corporation to its shareholders. The holding of investment securities does not constitute a trade or business.

Example (2). Corporation B is engaged in the business of manufacturing and selling hats in its own factory building. It proposes to transfer the factory building to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in connection with the manufacturing of hats constitute a trade or business; but the operation of the factory building does not.

Example (3). Corporation C, a bank, owns an eleven-story downtown office building, the ground floor of which is occupied by it in the conduct of its banking business and the remaining ten floors of which it rents to various tenants. The ten floors are rented, managed and maintained by the real estate department of the bank. It is proposed to transfer the building to a new corporation and distribute the stock of such new corporation to the bank's shareholders. The activities in connection with banking constitute a trade or business as do also the activities in connection with the rental of the building.

Example (4). Corporation D, a bank, owns a two-story building in a suburban area, the ground floor and approximately one-half of the second floor of which is occupied by it in the conduct of its banking business. The remainder of the second floor is rented as storage space to a neighboring retail merchant. It is proposed to transfer the building to a new corporation and distribute the stock of such new corporation to the bank's shareholders. With respect to the rental of part of the second floor of its building, the bank is not engaged in the active conduct of a trade or business, such activity being only incidental to its banking business.

Example (5). Corporation E is engaged in the manufacture and sale of wood products. In connection with such manufacturing, it maintains a research department for its own use. It proposes to transfer the research department to a new corporation after which it will engage the services of the new corporation on a contract basis. The activities of the research department do not constitute a trade or business.

Example (6). Corporation F owns and rents an office building and owns vacant land. It proposes to transfer

the vacant land to a new corporation and distribute the stock of such new corporation to its shareholders. The holding of the vacant land does not constitute a trade or business.

Example (7). Corporation G owns land on which it engages in the ranching business. Oil has been discovered in the area and it is apparent that oil may be found under the land on which the ranching activities are maintained. Corporation G has engaged in no activities in connection with the mineral rights. It proposes to transfer the mineral rights to a new corporation and distribute the stock of such new corporation to shareholders. Corporation G is not engaged in an active trade or business with respect to the mineral rights.

Example (8). Corporation H manufactures and sells ice cream at a plant in State X and at a plant in State Y. Corporation H proposes to transfer the plant and related activities in State Y to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in each State constitute a trade or business.

Example (9). Corporation I manufactures and sells ice cream in State X. It purchases land and constructs a new plant in State Y. After manufacturing and selling operations have commenced at the new plant, it proposes to transfer it to a new corporation and distribute the stock of such new corporation to its shareholders. The activities at the new plant constitute a trade or business which, however, has been in existence only since such activities began.

Example (10). Corporation J has owned and operated a men's retail clothing store in the downtown area of the City of R for seven years and has also

owned and operated a men's retail clothing store in the suburban area of the City of R for nine years. The manager of each store directs its operations and makes the necessary purchases. No common warehouse is maintained. Corporation J proposes to transfer the store building, fixtures, and inventory of the suburban store to a new corporation and distribute the stock of such new corporation to the shareholders of Corporation J. The activities of each store constitute a trade or business which has been in existence for more than five years.

Example (11). Corporation K processes and sells meat products. It is proposed to separate the selling from the manufacturing activities by forming a separate corporation, L, to handle sales. Corporation K will transfer to Corporation L cerain physical assets pertaining to the sales function plus cash for working capital in exchange for the capital stock of Corporation L which will be distributed to the shareholders of Corporation K. Since the manufacturing and selling operations constitute only one integrated business, neither Corporation K nor Corporation L will be continuing the active conduct of a trade or business formerly conducted by Corporation K.

Example (12). Corporation M is engaged in the manufacture and sale of steel and steel products. In addition, Corporation M owns and operates a coal mine for the sole purpose of supplying its coal requirements in the manufacture of steel. It is proposed to transfer the coal mine to a new corporation and distribute the stock of such new corporation to the shareholders of Corporation M. The activities of Corporation M in connection with the operation of the coal mine do not constitute a trade or business, since

such activities are not themselves independently producing income although a part of the business operated for profit.

Example (13). Corporation N manufactures steel containers for oil and oil products at a plant in State X and at a plant in State Y. Pursuant to a sales contract with Corporation O, Corporation N sells its entire product to Corporation O. Corporation N proposes to transfer the plant and related activities in State Y, together with that portion of the sales contract with Corporation O applicable to the sales of that plant to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in each State constitute a trade or business before and after the transfer to the new corporation.

Example (14). Corporation P manufactures and sells steel containers for oil and oil products at a plant in State X and at a plant in State Y. Corporation P makes all of its sales through its wholly-owned subsidiary pursuant to a sales contract, by virtue of which the subsidiary acts either as principal or sales agent for Corporation P. Corporation P proposes to transfer the plant and related activities in State Y, together with that portion of the sales contract applicable to the sales of that plant to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in each State constitute a trade or business before and after the transfer to the new corporation.

Example (15). Corporation Q manufactures electrical products at a plant in State X and at a plant in State Y. The sales of the electrical products produced by each plant are made by the corporation's sales office located at the plant in State X. Corporation Q

proposes to transfer the plant and related activities in State Y, together with that portion of the facilities and personnel of the sales office allocable to the sales of the plant in State Y to a new corporation and distribute the stock of such new corporation to its shareholders. The activities in each state constitute a trade or business before and after the transfer to the new corporation.

Example (16). Corporation R manufactures and sells automobiles and operates an executive dining room primarily for the convenience of its executives. The dining room is managed and operated as a separate unit and the executives are charged for their meals. Corporation R derives a profit from the operation of the dining room. The activities connected with the executive dining room do not constitute a trade or business.

(e) Businesses operated by one corporation. For further examples of businesses operated by one corporation, see paragraph (d) of §1.337-3.

Proposed Treas. Reg. §1.355-1 Distribution of stock and securities of a controlled corporation:

(a) Application of section. Section 355 provides for the separation, without recognition of gain or loss to the shareholders and security holders, of one or more existing businesses formerly operated, directly or indirectly, by a single corporation. It applies only to the separation for at least 5 years (or a business which has been in active operation for at least 5 years into separate businesses), and which, in general, have been owned, directly or indirectly, for at least 5 years by the corporation making the distribution of stock or of stock and securities. For the purpose of section 355,

stock rights or stock warrants are not included in the term "stock and securities".

(b) Type of separations. Section 355 is concerned with two general types of separations. The first is the distribution of the stock of an existing corporation. The second is the distribution of the stock of a corporation holding assets of a business previously operated by the distributing corporation. In both cases, section 355 contemplates the continued operation of the business or businesses existing prior to the separation.

* * *

(1.355-3(b))

(b) Active conduct of a trade or business defined—(1) In general. Section 355(b)(2) provides rules for determining whether any corporation is treated as engaged in the active conduct of a trade or business for purposes of ascertaining whether the distributing corporation and the controlled corporation meet the requirements of section 355(b)(1). Under section 355(b)(2)(A), a corporation is treated as engaged in the active of a trade or business if it is itself engaged in such a trade or business or if substantially all of its assets consist of the stock and securities of a corporation or corporations controlled by it (immediately after the distribution) each of which is engaged in the active conduct of a trade or business.

(2) Active conduct of trade or business immediately after distribution—(1) General. For purposes of section 355(b), a corporation shall be treated as engaged in the "active conduct of a trade or business" immediately after a distribution if the assets and activities of such corporation meet the tests and limitations described in paragraph (b)(2)(ii), (iii), and (iv) of this section.

(ii) Trade or business. A corporation shall be treated as engaged in a trade or business immediately after a distribution of stock if a specific group of activities are being carried on by such corporation for the purpose of earning income or profit from such group of activities, and the activities included in such group include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses.

(iii) Active conduct. For purposes to section 355, the determination of whether a trade or business is actively conducted is a question of fact to be determined under all the facts and circumstances. In general, the corporation must perform active and substantial management and operational functions.

(iv) Limitations. The active conduct of a trade or business does not include—

(A) The holding for investment purposes of stock, securities, land, or other property, or

(B) The ownership and operation (including leasing) of real or personal property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property.

(3) Active conduct for 5-year period preceding distribution. Under section 355(b)(2)(B), a trade or business must have been actively conducted for the 5-year period ending on the date of distribution of the stock and securities of the controlled corporation. For this purpose, activities which constitute a trade or business under the tests described in paragraph (b)(2) of this section, shall be treated as meeting the test contained in the preceding sentence if such activities

were actively conducted throughout such 5-year period. For the purpose of determining whether such trade or business has been actively conducted throughout the 5-year period described in section 355(b)(2), the fact that during such 5-year period such trade or business underwent change (for example, by the addition of new or the dropping of old products, changes in production capacity, and the like) shall be disregarded provided the changes are not of such a character as to constitute the acquisition of a new or different business.

* * *

Par. 2 Section 1.346-1 is amended by deleting the last sentence of paragraph (c) and by inserting in lieu thereof "The term 'active conduct of a trade or business' shall have the same meaning in this section as in §1.355-3(b)(2)."

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OCTOBER TERM, 1985

KENTON MEADOWS COMPANY, INC., ET AL.,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

CHARLES FRIED
Solicitor General

ROGER M. OLSEN
Acting Assistant Attorney General

MICHAED L. PAUP
JONATHAN S. COHEN
DAVID I. PINCUS
Attorneys
Department of Justice
Washington, D.C. 20530
(202) 633-2217

BEST AVAILABLE COPY

QUESTIONS PRESENTED

1. Whether the distribution of assets by the corporate petitioner to the individual petitioner constituted the termination of a business qualifying as a partial liquidation under Section 346(b) of the Internal Revenue Code of 1954 although the activity to which the distributed assets related was not a separate trade or business.

2. Whether, in any event, the distribution failed to qualify under that Section because the corporate petitioner did not distribute all of the proceeds from the sale of the assets.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statutes and regulations involved	2
Statement	2
Argument	5
Conclusion	12
Appendix	1a

TABLE OF AUTHORITIES

Cases:

Blaschka v. *United States*, 393 F.2d 983 ..... 6, 7, 10
Coady v. *Commissioner*, 33 T.C. 771, aff'd, 289 F.2d 490 ..... 8, 9, 10
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Krauskopf v. *Commissioner*, 53 T.C.M. (P-H) ¶ 84,386 7
Mains v. *United States*, 508 F.2d 1251 ..... 6, 7, 9
NLRB v. *Sears, Roebuck & Co.*, 421 U.S. 132 5
United States v. *Marett*, 325 F.2d 28 8

Statutes and regulations:

Internal Revenue Code of 1954 (26 U.S.C. (1970 ed.)):
§ 311(d)(1) 4
§ 331(a) 4
§ 346 ..... 2, 5, 6, 7, 8, 10, 1a
§ 346(b) 4, 5-6, 7, 8, 9, 10, 11, 1a
§ 355 ..... 2, 5, 7, 8, 9, 10, 11, 2a
Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 222, 96 Stat. 479 5
26 U.S.C. 302(e) 2, 5

Statutes and regulations—Continued: Page

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

Section 1.346-1 2
Section 1.346-1(c) 6, 11
Section 1.355-1 2
Section 1.355-1(a) 8
Section 1.355-1(c) 6, 11
Section 1.355-3(b)(2) 11

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J. Chommie, *Federal Income Taxation* (2d ed. 1973) 9
Rev. Rul. 64-147, 1964-1 Cum. Bull. (Pt. 1) 136 8
Rev. Rul. 75-160, 1975-1 Cum. Bull. 112 8
S. Rep. 1622, 83d Cong., 2d Sess. (1954) 9
2 S. Surrey, W. Warren, P. McDaniel & H. Ault, *Cases and Materials on Federal Income Taxation* (2d ed. 1980) 9

In the Supreme Court of the United States

OCTOBER TERM, 1985

No. 85-674

KENTON MEADOWS COMPANY, INC., ET AL.,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-7a) is reported at 766 F.2d 142. The opinion of the Tax Court (Pet. App. 9a-35a) is unofficially reported at 53 T.C.M. (P-H) ¶ 84,379.

JURISDICTION

The judgment of the court of appeals was entered on June 26, 1985, and rehearing was denied on July 23, 1985 (Pet. App. 8a). The petition for a writ of certiorari was filed on October 18, 1985. The juris-

diction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant portions of Sections 346 and 355 of the Internal Revenue Code of 1954 (26 U.S.C. (1970 ed.)), as they existed during the tax years at issue are set forth in the Appendix, *infra*, 1a-6a.[1] The relevant portions of Sections 1.346-1 and 1.355-1 of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.) are set forth at Pet. App. 57a-67a. The relevant portions of the proposed amendments to Treasury Regulations Sections 1.346-1 and 1.355-3 are set forth at Pet. App. 68a-70a.

STATEMENT

At all times relevant herein, individual petitioner Kenton Meadows (Meadows) was the sole shareholder of corporate petitioner Kenton Meadows Company, Inc. (the Company). Before 1972, the Company engaged in heavy construction and related activities, including pipeline construction and maintenance, asphalt paving, quarried stone sales, road and bridge construction, and equipment rental. The Company's pipeline business was concentrated in the construction of "cross-country" gas pipelines (Pet. App. 2a-3a).

In 1970-1971 the Company had a shortage of liquid assets and, as a result, experienced difficulty in securing the bonding necessary to obtain pipeline construc-

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[1] The current requirements concerning partial liquidations are in Section 302(e). In their statutory appendix (Pet. App. 53a-57a), petitioners reproduce the current versions of Sections 346 and 355, which have no relevance to the instant case.

tion contracts. To remedy this situation, Meadows transferred 150 shares of personally-owned bank stock to the Company, receiving 550 shares of Company stock in return. Meadows' basis in the transferred bank stock was $84,350. This transaction enabled the Company to obtain bonding for a major cross-country pipeline project. The Company completed this project by the end of 1971 (Pet. App. 3a).

In 1972, unable to locate additional cross-country pipeline work, the Company decided to sell certain pipeline-construction equipment known as "sidebooms." The Company sold seven sidebooms between January and March, 1972, for which it received a total of $238,234. This $238,234 was used to retire "pipeline-related debt" that had been collateralized not only by the sidebooms but also by multipurpose equipment that the Company retained. After 1972, the Company did not perform any cross-country pipelining work, although it continued to work on smaller "station" pipelining jobs. Pet. App. 3a-4a.

Also in 1972, the Company transferred the 150 shares of bank stock back to Meadows in redemption of the 550 shares of Company stock that it had previously transferred to him. At the time of this redemption (January 14, 1972), the fair market value of the bank stock had increased to $107,000 (Pet. App. 3a).

On audit, the Commissioner treated the Company's distribution of the bank stock to Meadows as a dividend to him (ordinary income), and thus increased Meadows' 1972 income by the $107,000 value of the bank stock. The Commissioner also increased the Company's income by $22,650, which reflected the amount of the appreciation of the bank stock while in the Company's hands (Pet. App. 19a).

In the Tax Court, petitioners contended that the distribution of the bank stock was part of a partial liquidation of the Company under Section 346(b) of the Internal Revenue Code, and thus that, by virtue of Section 331(a) of the Code, it resulted in only a capital gain to Meadows—a gain measured by the excess of the fair market value of the bank stock over his basis in the surrendered shares. The Tax Court, however, rejected petitioners' contention. It found that the distribution satisfied neither of two prerequisites to the applicability of Section 346(b)—(1) termination of a *separate* trade or business; and (2) distribution of *all* the assets, or proceeds from the sale of the assets, of the terminated business. It thus upheld the Commissioner's determination that Meadows had received a dividend in the amount of the value of the bank stock (Pet. App. 19a-32a). The court also sustained the Commissioner's determination that under Section 311(d)(1) of the Code the Company's income should be increased by $22,650 (Pet. App. 32a-33a).

The court of appeals affirmed. It held that to satisfy the "separate trade or business" requirement of Section 346(b) the corporate activities in question must have been operated under some form of separate supervision and control, and it agreed with the Tax Court that petitioners had "simply failed to carry their burden on this factor" (Pet. App. 4a-6a).[2] It further held that the Tax Court's decision

[2] Although the court of appeals deemed "questionable" (Pet. App. 5a) the Tax Court's finding (Pet. App. 24a n.15) that cross-country pipelining did not produce a substantial part of the Company's combined corporate income, that finding was merely an alternative ground for the Tax Court's inference of a lack of a "separate trade or business," and the court of ap-

was, in any event, correct because the Company had not distributed *all* of the proceeds of the sale of its cross-country pipelining assets: the proceeds of the sale of the sidebooms had been used in part to retire debt for which other equipment that the Company retained had served as collateral (Pet. App. 6a-7a).

In a petition for rehearing filed in the court of appeals, petitioners advanced, for the first time, their current contention that proposed amendments to the Treasury Regulations under Sections 346 and 355 had abrogated the "separate trade or business" test of Section 346(b). The court of appeals denied petitioners' petition for rehearing without comment (Pet. App. 8a).[3]

ARGUMENT

The decision of the court of appeals is correct and does not conflict with that of any other appellate court. Accordingly, the petition for a writ of certiorari should be denied.

1. During the tax years at issue, the definition of "partial liquidation" was contained in Section 346 of the Code.[4] Section 346(b)—the subsection at issue here—provided in essence that a distribution quali-

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peals' questioning of that finding was, accordingly, not dispositive.

[3] Thus, in this case, there is no lower court opinion discussing the main legal issue that petitioners raise here. This Court normally declines review in such situations. *NLRB* v. *Sears, Roebuck & Co.*, 421 U.S. 132, 163-164 (1975).

[4] Pursuant to changes made by the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. No. 97-248, § 222, 96 Stat. 479), partial liquidations are now governed by Section 302(e), rather than Section 346; the current provisions are closely similar to the ones involved here.

fied as a partial liquidation if, *inter alia*, the following requirements were met:

> (1) The distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution * * * [and]
>
> (2) Immediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution * * *.

As the above statutory language indicates, the corporation in question must have been engaged in the conduct of at least two separate trades or businesses, since there must have been at least one business that was terminated and at least one business that was continued in operation. See *Mains* v. *United States*, 508 F.2d 1251 (6th Cir. 1975); *Blaschka* v. *United States*, 393 F.2d 983 (Ct. Cl. 1968).

For the definition of "trade or business," the Regulations under Section 346 (26 C.F.R. 1.346-1(c)) incorporate by reference the definition of "trade or business" in 26 C.F.R. 1.355-1(c). This latter section defines a trade or business as—

> a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such groups must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses. * * *

From this definition of "trade or business" the courts have developed a two-part test for determining whether any given group of activities constitutes a "separate trade or business." Under this test, a group of activities constitutes a "separate trade or business" where it both (1) produces a substantial part of the combined corporate income, and (2) is under some form of separate supervision and control. See *Mains* v. *United States*, 508 F.2d at 1257-1258; *Blaschka* v. *United States*, 393 F.2d at 989-992; *Krauskopf* v. *Commissioner*, 53 T.C.M. (P-H) ¶ 84,386, at 1507 (1984).

In the case at bar, the Tax Court (Pet. App. 24a n.15, 26a-27a) and the court of appeals (Pet. App. 5a-6a) correctly found that there was "no evidence of any separation of supervision and control of the purportedly separate cross-country pipelining business" (Pet. App. 25a n.15).[5] Accordingly, it is plain that the Company's termination of its cross-country pipeline business did not constitute the termination of a "separate trade or business" as required for partial liquidation treatment under Section 346(b).

2. Petitioners rely for their conflict claims on the case law and proposed regulations under Section 355 of the Internal Revenue Code of 1954—not Section 346. Their reliance is misplaced, because the two Sections deal with entirely different subjects. While Section 346 deals with partial liquidations, Section 355 provides for the separation, without recognition of gain or loss to the shareholders, of one or more existing businesses formerly operated by a single corporation. Petitioners' contention assumes that be-

[5] Petitioners do not challenge the accuracy of this concurrent conclusion by both courts below; they contend only that it was irrelevant.

cause Section 355 does not contain a separate business requirement, neither does Section 346. This is simply incorrect.

Neither the statutory language nor the legislative history of Section 355 indicates that tax-free treatment under that Section may be denied to an otherwise-qualifying transaction on the ground that it represents the division of a "single" trade or business.[6] By contrast, both the wording of Section 346 (b) and the legislative history thereof make it plain that the existence of two or more separate businesses is a prerequisite to that Section's application. Specifically, paragraphs (1) and (2) of Section 346(b) by their terms require both the termination of one business and the continuation of one business, and

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[6] Prior to 1964, the Commissioner, relying on Section 1.355-1(a) of the Treasury Regulations, had taken the position that Section 355 applied only where the corporation in question had conducted two or more separate businesses, *i.e.*, that it did not apply to the division of a single business. After suffering losses in *Coady* v. *Commissioner*, 33 T.C. 771 (1960), aff'd, 289 F.2d 490 (6th Cir. 1961), and *United States* v. *Marett*, 325 F.2d 28 (5th Cir. 1963), however, the Commissioner reversed his position and announced, in Rev. Rul. 64-147, 1964-1 Cum. Bull. (Pt. 1) 136, that he would follow *Coady* and *Marett* "to the extent they hold that section 1.355-1(a) of the Income Tax Regulations, providing that section 355 of the Internal Revenue Code of 1954 does not apply to the division of a single business, is invalid." Accord, Rev. Rul. 75-160, 1975-1 Cum. Bull. 112. The Commissioner in 1977 accordingly issued proposed amendments to the regulations under Section 355 that made it clear that the separate business rule was being abandoned for purposes of Section 355 (42 Fed. Reg. 3867 (1977)). Neither the rulings nor the proposed amendments contain any suggestion that this abandonment of the separate business rule applies to Section 346 as well.

the Senate Finance Committee Report explains that paragraphs (1) and (2) of Section 346(b) "contemplate that the distributing corporation must be engaged in the active conduct of *at least 2 businesses* which have been actively conducted" for the statutory period (S. Rep. 1622, 83d Cong., 2d Sess. 262 (1954) (emphasis added)).

The commentators similarly distinguish between these two sections. 2 S. Surrey, W. Warren, P. McDaniel & H. Ault, *Cases and Materials on Federal Income Taxation*, at 501 (2d ed. 1980) ("[w]hile the division of a single business may be accomplished under section 355, section 346(b) contemplates the existence of two separate trades or businesses"); J. Chommie, *Federal Income Taxation* 592 n.84 (2d ed. 1973) (although the courts have refused to limit Section 355 to situations where a corporation operated two or more distinct businesses prior to the separation, that result is one "hardly likely to be reached under section 346(b)"); Burke & Parker, *Partial Liquidations Under Section 346: Planning, Problems and Procedures*, 24 Baylor L. Rev. 1, 37 (1972) (unlike the situation under Section 355, to which the *Coady* case (note 6, *supra*) applies, it "is clear * * * that a prerequisite of Section 346(b) is the existence of two or more separate businesses, since one business must be terminated and one business must be continued in operation after the distribution in partial liquidation").

Further evidence that the conflict asserted by petitioners between the case at bar and those decided under Section 355 does not exist is provided by the Sixth Circuit's decision in *Mains* v. *United States*, *supra*. *Mains*, like the instant case, involved Section 346(b), and, in applying that Section, the Sixth Circuit in 1975 used the same "separate trade or busi-

ness" test that the lower courts used herein—the test that petitioners contend had been abrogated in 1961 by the Sixth Circuit in *Coady* v. *Commissioner*, 289 F.2d 490. In its *Mains* brief the government pointed out that cases interpreting Section 355 were not on point,[7] and the Sixth Circuit apparently accepted that proposition: it concluded that Section 346(b) was inapplicable to the transaction at issue because there had been no separate trade or business, without mentioning *Coady* (508 F.2d at 1257-1258).[8]

As petitioners point out (Pet. 7), a proposed amendment to the Regulations under Section 346

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[7] The Government's brief stated (at 31 n.10):

> This Court has previously declined to follow * * * [a] portion of the Treasury Regulations under Section 355 which would limit the application of that section to the separation of two or more existing businesses. *Coady* v. *Commissioner*, 289 F.2d 490 (1961), aff'g *per curiam*, 33 T.C. 771 (1960), and the Internal Revenue Service has announced that it will follow that decision (as well as the similar decision of the Fifth Circuit in *United States* v. *Marett*, 325 F.2d 28 (1963)). Rev. Rul. 64-147, 1964-1 Cum. Bull. (Part 1) 136. Unlike Section 355, Section 346(b) on its face envisions the existence of two separate businesses, one of which is terminated, and the legislative history is equally clear as to the statutory intent in this regard. Moreover, neither *Coady* nor *Marett* questioned the validity of Section 1.355-1(c) of the Regulations, which we submit clearly fall within the range of permissible administrative construction of the statutory provisions here in question. See *Bingler* v. *Johnson*, 394 U.S. 741, 744-751 (1969); *United States* v. *Correll*, 389 U.S. 299, 306-307 (1967).

[8] Similarly, *Blaschka* v. *United States*, 393 F.2d at 989-992, refused to apply Section 346(b) because there was no separate trade or business, without referring to the previously decided cases interpreting Section 355 upon which petitioners rely.

(26 C.F.R. 1.346-1(c)) cross-references a portion of the proposed amendments to the Regulations under Section 355. But that cross-reference is solely to the definition of "active conduct of a trade or business" in the proposed amendment to Section 1.355-3(b)(2). This definition is essentially a restatement of the definition contained in current Regulations Section 1.355-1(c). In patricular, the proposed amendment contains the same "every step" requirement[9] that was applied by the courts below (Pet. App. 5a, 25a), and that petitioners allege has been abandoned (Pet. 8, 12, 14, 15). Thus, the proposed amendments to the Regulations are entirely consistent with the instant decision.

3. In any event, the alternative ground relied upon by the courts below (Pet. App. 6a-7a, 29a-32a) provides ample independent support for their decisions. In order to qualify under Section 346(b), the distribution in question must be of all of the assets of the terminated business, or, if the assets are sold, of all of the proceeds from that sale. *Gordon* v. *Commissioner*, 424 F.2d 378, 385-387 (2d Cir.), cert. denied, 400 U.S. 848 (1970).[10] Here, the Company

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[9] The "every step" requirement means that if the activities in question are to be considered "trade or business" they must include every operation which forms a part of, or a step in, the process of earning income or profit from such activity.

[10] Thus, at the very least, petitioners' reliance on Section 346(b) assumes that the only assets of the terminated business were the sidebooms and the contributed stock. But the Tax Court noted (Pet. App. 29a) that other construction equipment used in the company's cross-country pipeline activities was not sold. That court thus properly concluded that "[w]e do not think that the sale of assets which occurred in this case is of the type contemplated by section 346(b)" (*ibid.*).

sold the sidebooms used in cross-country pipelining, but did not distribute any of the proceeds. Instead, it used the proceeds to retire corporate debt—debt that was collateralized not only by the sidebooms but also by other equipment that was used in other corporate activities and that was retained by the Company (Pet. App. 7a, 31a-32a).[11] Petitioners do not here question the correctness of the reliance by the courts below on this alternative ground. For this additional reason, the judgment below does not warrant review by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

CHARLES FRIED
Solicitor General

ROGER M. OLSEN
Acting Assistant Attorney General

MICHAED L. PAUP
JONATHAN S. COHEN
DAVID I. PINCUS
Attorneys

DECEMBER 1985

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[11] To the extent the proceeds of the sale of the sidebooms were used to retire debts collateralized by equipment retained by the company, those proceeds were in effect reinvested in the company.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C. (1970 ed.)):

SECTION 346. PARTIAL LIQUIDATION DEFINED.

(a) *In General.*—For purposes of this subchapter, a distribution shall be treated as in partial liquidation of a corporation if—

(1) the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan; or

(2) the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year, including (but not limited to) a distribution which meets the requirements of subsection (b).

For purposes of section 562(b) (relating to the dividends paid deduction) and section 6043 (relating to information returns), a partial liquidation includes a redemption of stock to which section 302 applies.

(b) *Termination of a Business.*—A distribution shall be treated as a distribution described in subsection (a)(2) if the requirements of paragraphs (1) and (2) of this subsection are met.

(1) The distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business

which has been actively conducted throughout the 5 year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

(2) Immediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution and was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

Whether or not a distribution meets the requirements of paragraphs (1) and (2) of this subsection shall be determined without regard to whether or not the distribution is pro rata with respect to all of the shareholders of the corporation.

* * * * *

SECTION 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) *Effect on Distributees.*—

(1) *General rule.*—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporation are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

* * * * *

(b) *Requirements as to Active Business.*—

(1) *In general.*—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is en-

gaged immediately after the distribution in the active conduct of a trade or business.

(2) *Definition.*—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired

only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

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